DOCKET

No. 89-1926-CFX
Status: GRANTED

Title: United States, Petitioner
v.
Centennial Savings Bank FSB (Resolution Trust Corporation, Receiver)

Docketed:
June 8, 1990

Court: United States Court of Appeals for the Fifth Circuit

See also:
89-1927
89-1928
89-1987

Counsel for petitioner: Roberts Jr.,John G.

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5/4: Ord. granting ext. of time to file, to and incl. 6/8, by White, J. (CITED); 40 printed copies recd. 6/8.

Entry	Date	Note	Proceedings and Orders
1	Apr 6 1990	G	Application (A89-704) to extend the time to file a petition for a writ of certiorari from April 19, 1990 to May 18, 1990, submitted to Justice White.
2	Apr 10 1990		Application (A89-704) granted by Justice White extending the time to file until May 18, 1990.
3	May 3 1990	G	Application (A89-704) to extend further the time to file a petition for a writ of certiorari from May 18, 1990 to June 8, 1990, submitted to Justice White.
4	May 4 1990		Application (A89-704) granted by Justice White extending the time to file until June 8, 1990.
5	Jun 8 1990	G	Petition for writ of certiorari filed.
7	Jun 29 1990		Order extending time to file response to petition until August 8, 1990.
8	Jul 6 1990		Brief amicus curiae of U.S. League of Savings Institutions filed. VIDED.
9	Jul 27 1990		Order further extending time to file response to petition until August 31, 1990.
10	Aug 31 1990		Brief of respondent Resolution Trust Corporation in opposition filed.
11	Sep 5 1990		DISTRIBUTED. September 24, 1990
12	Sep 12 1990	X	Reply brief of petitioner United States filed.
13	Oct 1 1990		Petition GRANTED. The case is set for oral argument in tandem with No. 89-1965, Cottage Savings Association v. Commissioner of Internal Revenue.
			**********
14	Oct 18 1990		Record filed.
		*	Certified copy of original record, 9 volumes, received. (Box).
15	Oct 19 1990		Record filed.
		*	Certified copy of C. A. Proceedings received.
16	Nov 15 1990		Brief of petitioner United States filed.
17	Nov 15 1990		Joint appendix filed.
18	Nov 23 1990		SET FOR ARGUMENT TUESDAY, JANUARY 15, 1991. (1ST CASE)
19	Nov 28 1990		CIRCULATED.
20	Dec 14 1990	X	Brief amicus curiae of U.S. League of Savings Institutions filed.

No. 89-1926-CFX

Entry	Date	Note	Proceedings and Orders
21	Dec 17 1990	X	Brief of respondent filed.
22	Dec 17 1990	X	Brief amicus curiae of Federal National Mortgage Association filed.
23	Dec 17 1990		Lodging received.
25	Dec 17 1990	X	Brief amici curiae of Main Line Federal Savings Bank, et al. filed.
26	Jan 4 1991	X	Reply brief of petitioner United States filed.
27	Jan 15 1991		ARGUED.

PETITION FOR WRIT OF CERTIORARI

89-1928

No.

Supreme Court, U.S.
FILED
JUN 8 1990
JOSEPH F. SPANIOL, JR.
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1989

UNITED STATES OF AMERICA, PETITIONER

v.

CENTENNIAL SAVINGS BANK FSB
(RESOLUTION TRUST CORPORATION, RECEIVER)

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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QUESTIONS PRESENTED

1. Whether a financial institution realizes a deductible loss for income tax purposes when it exchanges a group of mortgage loans for a substantially identical group of mortgage loans held by another financial institution.

2. Whether income received by a financial institution from its depositors as penalties for early withdrawal of their funds is excludable from gross income as income from "the discharge * * * of indebtedness," within the meaning of Section 108 of the Internal Revenue Code.

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In the Supreme Court of the United States

OCTOBER TERM, 1989

No.

UNITED STATES OF AMERICA, PETITIONER

v.

CENTENNIAL SAVINGS BANK FSB
(RESOLUTION TRUST CORPORATION, RECEIVER)

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Acting Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-29a) is reported at 887 F.2d 595. The opinion of the district court (App., *infra*, 30a-60a) is reported at 682 F. Supp. 1389.

JURISDICTION

The judgment of the court of appeals was entered on November 2, 1989. A petition for rehearing was denied on January 19, 1990 (App., *infra*, 61a-62a). On April 10,

1990, Justice White extended the time within which to file a petition for a writ of certiorari to and including May 18, 1990. On May 4, 1990, Justice White further extended that time to and including June 8, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS AND REGULATION INVOLVED

The relevant portions of Sections 108, 165, and 1001 of the Internal Revenue Code of 1954 (26 U.S.C. (1982)) and Section 1.1001-1(a) of the Treasury Regulations on Income Tax (26 C.F.R.) are set out in a statutory appendix (App., *infra*, 63a-66a).

STATEMENT

1. a. Respondent is a mutual savings and loan association formerly regulated by the Federal Home Loan Bank Board. In 1981, respondent's mortgage loan portfolio was comprised primarily of fixed-rate, long-term home mortgage loans that had been issued in the late 1960s at interest rates significantly lower than those charged on more recent loans. As a result of the high interest rates of the early 1980s, the fair market value of these older, low-interest loans fell far below their face amount. App., *infra*, 31a.

For respondent, like other savings institutions holding older, low-interest loans, this situation created a tax incentive for disposing of its depreciated mortgage loans. A disposition of the loans would enable respondent to realize for tax purposes the loss that resulted from these market changes; it could then utilize the resulting loss deductions to offset current taxable income and produce loss carrybacks that would generate tax refunds from prior years. There was, however, a catch. Many of these institutions were in such precarious financial condition that a sale of

the loans and consequent recognition of the losses—however beneficial for tax purposes—would for regulatory accounting purposes have caused them to fail to meet the Bank Board's minimum reserve and liquidity requirements, raising the prospect of closure by the Bank Board. See App., *infra*, 31a-32a; *San Antonio Savings Ass'n* v. *Commissioner*, 887 F.2d 577, 579 (5th Cir. 1989).

On June 27, 1980, the Bank Board's Office of Examination and Supervision (OES) issued Memorandum R-49, a regulatory accounting principle that adopted the rule that savings institutions could make "reciprocal sales" of depreciated "substantially identical mortgage loans" without having to record a loss for regulatory accounting purposes. Memorandum R-49 established a list of criteria that would render loans "substantially identical," including that the mortgages be of similar type with the same terms and interest rates.[1] The admitted objective of Memoran-

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[1] Memorandum R-49 specifically provided in part (App., *infra*, 32a-33a):

> A loss resulting from a difference between market value and book value in connection with reciprocal sales of substantially identical mortgage loans need not be recorded. Mortgage loans are considered substantially identical only when each of the following criteria is met. The loans involved must:
>
> 1. involve single-family residential mortgages,
> 2. be of similar type (e.g., conventionals for conventionals),
> 3. have the same stated terms to maturity (e.g. 30 years),
> 4. have identical stated interest rates,
> 5. have similar seasoning (i.e., remaining terms to maturity),
> 6. have aggregate principal amounts within the lesser of 2½% or $100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,
> 7. be sold without recourse,
> 8. have similar fair market values,

dum R-49 was to allow savings institutions to engage in transactions that would generate deductible losses for federal income tax purposes, but that would not be treated as giving rise to losses for financial reporting and regulatory purposes. See App., *infra*, 53a-54a; *San Antonio Savings Ass'n* v. *Commissioner*, 887 F.2d at 579-580.[2]

On April 13, 1981, respondent entered into a transaction in which it effectively exchanged a package of interests in a group of residential mortgage loans for a package of interests in a group of residential mortgage loans held by the Federal National Mortgage Association (FNMA), a congressionally chartered, but privately owned, corporation that is the principal buyer and seller of mortgages in the secondary mortgage market. The interests were exchanged through "reciprocal sales" of conventional and FHA/VA loan packages having almost identical face and market values. The parties planned the transaction so as to ensure that the exchanged loans met the requirements of Memorandum R-49. FNMA used a computer to match respondent's loans with its own loans, and it then sent to respondent a list of FNMA loans that it proposed to exchange for a group of respondent's loans. Respondent agreed to acquire all of the proposed loans, without conducting any new credit checks, appraisals, or underwriting of those loans and without reviewing any of the relevant

9. have similar loan-to-value ratios at the time of the reciprocal sale, and
10. have all security properties for both sides of the transaction in the same state.

[2] A memorandum from the Director of OES to an officer of the Bank Board described the "objective" of Memorandum R-49 as "to structure a transaction which was as close as possible to the IRS 'materially different' definition which would still not change the economic position of the association after it engaged in the swap." See *San Antonio Savings Ass'n* v. *Commissioner*, 887 F.2d at 580.

mortgage file documents. The valuation of all of the loans was established by reference to FNMA's new money auction rate for April 1981. To arrive at a sale price, one discount factor was applied to each side of the transaction on all conventional loans and another discount factor was applied to all FHA/VA loans. App., *infra*, 35a-37a.

The transaction was styled a "reciprocal sale" and was consummated by conveyance of 90% participation interests in each loan together with a simultaneous wire transfer of money by respondent and FNMA to each other's account.[3] Respondent thus paid FNMA $5,662,045 for participation interests with a face amount of $8,481,264, while at the same time FNMA paid respondent $5,662,043 for participation interests with a face amount of $8,481,261. In effect, respondent exchanged participation interests with a face amount (and cost basis) of $8,481,261, but a much lower value, for participation interests of almost equal value. On its 1981 federal income tax return, respondent claimed a deduction for a loss on the transaction of $2,819,218, the difference between the face amount and value of the participation interests that it transferred. Pursuant to Memorandum R-49, however, respondent did not report any loss for financial and regulatory accounting purposes. App., *infra*, 2a-3a, 34a-35a.

b. During 1981, respondent had many certificates of deposit outstanding. Each certificate of deposit agreement established the interest rate to be paid on the deposit and a fixed term for which the depositor was to keep the funds on deposit with respondent. If a depositor chose to with-

[3] Transactions designed to take advantage of Memorandum R-49 often involved exchanges of 90% participation interests, rather than the entire loan, so that the original mortgagee could maintain its relationship with the obligor on the loans. See *Cottage Savings Ass'n* v. *Commissioner*, 90 T.C. 372, 381 (1988), rev'd, 890 F.2d 848 (6th Cir. 1989).

draw the principal from one of these accounts prior to maturity, federal regulations required the depositor to pay an "early withdrawal penalty" to respondent. See 12 C.F.R. 526.7 (1979); 12 C.F.R. 526.7 (1980); 12 C.F.R. 1204.103 (1981). Under the terms of the certificates, when a depositor incurred a penalty for withdrawing his deposit before expiration of the fixed term he would receive a single net payment from respondent—consisting of the principal on deposit plus interest payable to the date of withdrawal, less the penalty. The penalty thus was "paid" not by a direct transfer of funds from the depositor to respondent, but rather by subtracting the amount of the penalty from the amount paid to the depositor on the certificate. App., *infra*, 11a & n.4, 54a-55a.

During 1981, respondent received $258,019 in early withdrawal penalties. On its 1981 return, respondent treated the penalties as income from the discharge of indebtedness (see 26 U.S.C. 61(a)(12)), and it excluded that amount from its gross income under Section 108 of the Code.[4] App., *infra*, 4a, 55a. In 1981, that statute effectively allowed a taxpayer to defer the recognition of amounts included in gross income by reason of the discharge of indebtedness by generally providing that such income could be excluded from gross income if the taxpayer made an election under Section 1017 of the Code to reduce the basis of its depreciable property by the amount excluded.[5]

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[4] Unless otherwise indicated, statutory references are to the Internal Revenue Code of 1954 (26 U.S.C. (1982)), as in effect for the years at issue (the Code or I.R.C.).

[5] Section 108 was amended by the Tax Reform Act of 1986 to limit its application, for future years, to situations in which the taxpayer is insolvent or the discharge of indebtedness occurs in a bankruptcy case. See Pub. L. No. 99-514, § 822(a), 100 Stat. 2373.

2. On audit, the IRS determined that respondent was not entitled to its claimed deduction for a loss on the mortgage exchange transaction. The IRS further determined that respondent was required to include the early withdrawal penalties in gross income. Respondent paid the resulting income tax deficiencies and filed this refund action in the United States District Court for the Northern District of Texas. App., *infra*, 3a-4a.[6] After a bench trial, the district court ruled for the government on the mortgage swap issue and for respondent on the early withdrawal penalty issue (*id.* at 30a-60a).

a. The court first concluded that, even though the mortgage transaction had been structured as two simultaneous reciprocal sales, it was essentially an exchange of mortgage loans (App., *infra*, 44a-47a). It then concluded that this exchange was not an event that gives rise to realization of gain or loss under Section 1001 of the Code (*id.* at 47a-54a). Relying on Treas. Reg. § 1.1001-1(a) and addressing the relevant case law, the court explained that a loss is realized on an exchange of properties only if the properties are "materially different" (*id.* at 47a-50a). The court then held that, considering the "economic realities in existence *at the time of the transaction*" (*id.* at 51a), the mortgages exchanged here were not materially different, and hence the exchange could not give rise to a deductible

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[6] Respondent reported a net operating loss on its 1981 return. It carried back this loss to the years 1969, 1970, and 1972-1980, resulting in overpayments of taxes for those years. Respondent filed claims for tentative refunds of those overpayments, and the IRS disbursed the claimed refunds. The IRS disallowed the net operating loss claimed for 1981 and made an assessment against respondent in the amount of $788,634 plus interest. App., *infra*, 3a-4a. Thus, although the two issues presented here relate to respondent's income tax liability for 1981, the amounts at issue involve the refunds claimed by respondent for earlier tax years, based on net operating loss carrybacks from 1981.

loss (*id.* at 50a-54a). The court explained that the exchanged loans had been carefully selected so that they would be viewed as "substantially identical" under Memorandum R-49, and it concluded that "[t]he R-49 criteria assured that the mortgages after the matching process would not be materially different" (*id.* at 51a). The court recognized that each individual loan was different from the others, but it found that the " 'pools' of mortgages * * * were swapped with little if any reference to possible differences in the individual characteristics of the loans involved"; it then concluded that it is "difficult to attach significance to loan characteristics of which [respondent] itself had no knowledge at the time of the transaction." *Id.* at 52a.

b. The court agreed with respondent that the early withdrawal penalties were income by reason of the discharge of indebtedness that could be excluded from gross income under Section 108 of the Code (App., *infra*, 54a-60a). The court stated that "the penalty provision is an integral part of the contract, not merely an ancillary 'method' or 'medium' by which the debt was reduced" and therefore "the penalty income was liquidated debt, not liquidated damages" (*id.* at 59a). The court concluded that "income received by [respondent] from premature withdrawals was a direct result of depositors discharging [respondent] from its indebtedness to them" (*ibid.*).

3. Both parties appealed, and the court of appeals reversed the district court's decision with respect to the mortgage exchange issue and affirmed with respect to the early withdrawal penalty issue (App., *infra*, 1a-29a). This case was heard together with two other cases involving mortgage exchanges that satisfied the criteria of Memorandum R-49, and all three cases were decided by the same panel on the same day. See *San Antonio Savings Ass'n* v. *Commissioner, supra*; *First Federal Savings & Loan Ass'n* v. *United States*, 887 F.2d 593 (5th Cir. 1989).

a. The court of appeals treated *San Antonio* as the lead case, and it held there that an exchange of mortgages that satisfied the criteria of Memorandum R-49 could still give rise to a deductible loss for tax purposes. The court of appeals agreed with the district court and the government that a loss is realized on an exchange only if the properties exchanged are materially different (887 F.2d at 581-587). The court observed that, if the rule were otherwise, there would be "no limits on realization through meaningless exchanges," such as an exchange of different bushels of indistinguishable wheat (*id.* at 583). After an extensive review of the case law, the court concluded that "there is a material difference requirement which has been developed by the cases and confirmed by the Treasury Regulations" (*id.* at 587). The court then held, however, that the mortgages exchanged in an R-49 transaction are "materially different" because the mortgages have different borrowers and different collateral, even though the Bank Board had identified the mortgages as "substantially identical" (*id.* at 587-592). The court acknowledged that these variations made no difference to the parties to the exchange, but it stated that "[i]t must be the objective and not subjective factors, * * * which determine whether a realization event occurred" (*id.* at 590). The court also rejected the government's additional argument that the exchange lacked economic substance and therefore that no loss could be deducted under Section 165 of the Code (*id.* at 592-593).

In this case, the court observed that the facts relevant to the mortgage exchange issue were essentially the same as the facts in *San Antonio* (App., *infra*, 3a). Accordingly, it held that respondent's "R-49 transaction resulted in a realized and recognizable loss for tax purposes because the participation interests exchanged were in mortgages which under the Internal Revenue Code differed materially from each other" (*id.* at 9a).

b. The court of appeals agreed with the district court that the early withdrawal penalties received by respondent constituted income from the discharge of indebtedness and therefore that respondent was entitled to defer reporting that income pursuant to Section 108 of the Code (App., *infra*, 9a-28a). The court stated that the determination whether income should be regarded as "from the discharge of indebtedness" "focus[es] on the final result"—specifically, "on the spread between the amount received by the debtor and the amount paid by him to satisfy his obligation" (*id.* at 12a). The court reasoned that this approach supported respondent's position here since the effect of the penalty was to reduce respondent's net obligation to its depositor (*ibid.*), and it found no reason to reach a different result. In so holding, the court expressly disagreed (*id.* at 28a) with the decisions of the Tax Court and the Seventh Circuit in *Colonial Savings Ass'n* v. *Commissioner*, 85 T.C. 855 (1985), aff'd, 854 F.2d 1001 (7th Cir. 1988), cert. denied, 109 S. Ct. 1556 (1989), which had both concluded that early withdrawal penalties do not constitute income from the discharge of indebtedness that may be excluded under Section 108.[7]

REASONS FOR GRANTING THE PETITION

This case presents two unrelated questions concerning the federal income tax treatment of two kinds of transactions engaged in by savings and loan associations and

[7] While the case was pending on appeal, respondent was found insolvent by the Bank Board, and the Federal Savings and Loan Insurance Corporation was appointed as receiver. Subsequently, the Resolution Trust Corporation (RTC) took over as receiver. By statute, the Federal Deposit Insurance Corporation "perform[s] all responsibilities" of the RTC. See Section 501 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 369 (to be codified at 12 U.S.C. 1441a(b)(1)(C)).

other financial institutions. Because these kinds of transactions were and are common to the operations of many such institutions, the resolution of each question affects numerous financial institutions around the country and involves many millions of dollars. Moreover, there is a direct conflict in the circuits with respect to each of these questions of industry-wide significance. Unless these conflicts are resolved by this Court, taxpayers will receive disparate treatment, based entirely upon the happenstance of their geographical location, in numerous cases involving substantial sums of money.

1. The decision of the court below with respect to the tax treatment of the mortgage exchange transactions directly conflicts with the Sixth Circuit's decision in *Cottage Savings Ass'n* v. *Commissioner*, 890 F.2d 848 (1989). In this case (and in its decision in the lead case of *San Antonio Savings Ass'n* v. *Commissioner*, 887 F.2d 577 (1989)), the Fifth Circuit has held that pools of mortgages regarded as "substantially identical" by the parties and by the Federal Home Loan Bank Board under Memorandum R-49 are nonetheless "materially different" for tax purposes. Therefore, under the Fifth Circuit's holdings, exchanges of "substantially identical" mortgage interests that have depreciated in value are events that allow taxpayers to realize their losses and to use those losses to offset their taxable income. The Sixth Circuit took a different approach and reached the contrary conclusion in *Cottage Savings*. The court there held that because the exchange of mortgages pursuant to Memorandum R-49 did not result in any real change in the taxpayer's economic position, the taxpayer had not "sustained" a loss on that transaction that would permit it to take a loss deduction under Section 165 of the Code. In particular, the court stated that loss deductions are not allowed on "transactions in which the taxpayer's economic position was not changed for the

worse" (890 F.2d at 854), and it concluded that a savings institution's "economic position was not changed" by an exchange of a pool of mortgages for "a substantially identical pool of mortgages" (*id.* at 855).

The decisions of these two circuits are irreconcilable. The Sixth Circuit in *Cottage Savings* held that no loss is "sustained" within the meaning of Section 165 upon a Memorandum R-49 mortgage exchange and therefore that such an exchange does not permit the taxpayer to take a loss deduction. The Fifth Circuit, by contrast, explicitly held that the Memorandum R-49 exchanges of substantially identical mortgages solely to achieve a tax benefit did result in a loss deductible under Section 165. See *San Antonio*, 887 F.2d at 592-593.[8] This disagreement between the circuits will lead to different results in every case involving an exchange of depreciated mortgages that meet the criteria of Memorandum R-49. Under the Fifth Circuit's rule, a loss is realized upon such an exchange, and that loss may be deducted. Under the Sixth Circuit's rule, such an exchange lacks sufficient economic substance to permit the deduction of any loss.

There is no prospect that this conflict among the circuits will be resolved without the intervention of this Court. The government sought rehearing en banc of the Fifth Circuit cases, calling to the court's attention the contrary decision

[8] The Fifth Circuit accepted the government's submission that no loss may be "realized" under Section 1001 upon an exchange of properties that are not "materially different." The court then proceeded to hold that the exchanged mortgages satisfied that standard. The Sixth Circuit, by contrast, held that there is no "materially different" requirement for realization of gain or loss on an exchange. Accordingly, it did not explicitly address the question whether these mortgages were "materially different," but instead proceeded directly to the question whether there was a loss that could be deducted under Section 165 and concluded that no deductible loss had been sustained because there was no real change in the taxpayer's economic position.

in *Cottage Savings*, but the court of appeals denied the petition.[9] By the same token, the taxpayer in *Cottage Savings* sought rehearing en banc in the Sixth Circuit, calling to the court's attention the conflict with the Fifth Circuit. The Sixth Circuit denied rehearing on March 14, 1990. The continuation of this conflict will lead to disparate results among taxpayers in numerous cases involving enormous sums. The IRS has advised that there are currently pending administratively and in the courts 96 cases involving approximately $419 million in taxes (excluding interest) that turn on the resolution of the mortgage exchange issue. Accordingly, it is appropriate for this Court to grant certiorari here in order to resolve the conflict in the circuits on this issue of industry-wide significance.[10]

[9] In addition, the D.C. Circuit has recently decided the same issue in agreement with the position of the Fifth Circuit below. See *Federal Nat'l Mortgage Ass'n* v. *Commissioner*, 896 F.2d 580, 583-585 (1990).

[10] As we have noted, three cases decided by the Fifth Circuit on the same day present the mortgage exchange issue. We urge the Court to grant certiorari in this one because it also presents a second issue of industry-wide significance and considerable administrative importance. See pages 20-26, *infra*. We have also filed today a petition for certiorari from the court's judgment in *First Federal Savings & Loan Ass'n* v. *United States*, 887 F.2d 593 (5th Cir. 1989). Because that case involves a solvent savings institution, and this case involves an institution in RTC receivership, we believe that it would be appropriate also to grant the petition in *First Federal*. The taxpayer in *San Antonio Savings Ass'n* v. *Commissioner, supra*, is also in RTC receivership, and there is a question whether the tax deficiency in that case, if sustained, can ever be collected. Because this doubt about the collectibility of the deficiency in turn raises a question of mootness (see *Triland Holdings & Co.* v. *Sunbelt Service Corp.*, 884 F.2d 205, 208 (5th Cir. 1989)), we do not urge the Court to grant plenary review in *San Antonio*, but rather suggest that the petition in that case (filed today) be held pending the Court's resolution of the mortgage exchange issue in another case. In contrast to *San Antonio*, the insolvency of the taxpayer in this case presents no question of collectibility or mootness because this is a refund suit in which the United States has possession of the disputed taxes, and the question is whether those amounts must be refunded.

2. The court below erred in holding that mortgage exchanges designed to meet the Memorandum R-49 criteria for "substantially identical" mortgage pools give rise to a deductible loss. It is black letter law that the Internal Revenue Code generally takes into account increases and decreases in the value of property, other than inventory, only when gains or losses are "realized" in a taxable event that disposes of the property. See I.R.C. § 1001; see also I.R.C. § 165(a) (deduction allowed for "any loss sustained during the taxable year * * * "). And the Treasury Regulations have long defined a realization event in terms of the conversion of property into cash or an "exchange of property for other property differing materially either in kind or in extent." Treas. Reg. § 1.1001-1(a).[11]

This requirement that exchanged property be materially different if an exchange is to constitute a realization event reflects one of the fundamental principles of taxation—that the substance rather than the form of a transaction determines its tax consequences. See, *e.g.*, *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334 (1945); *Gregory* v. *Helvering*, 293 U.S. 465, 469-470 (1935). In particular, this Court has recognized that a taxpayer cannot deduct a loss generated by a transaction that lacks economic substance. See *Higgins* v. *Smith*, 308 U.S. 473 (1940) (sale of devalued stock to taxpayer's wholly-owned corporation). A taxpayer who exchanges property for other property that is not materially different has disposed of his property only as a matter of form, but there is no change in substance because the taxpayer is in essentially the same position as before the transaction. Accordingly, as the court of appeals below correctly held here and in its decision in *San Antonio*, 887 F.2d at 581-587, "a 'material difference' is required between exchanged items before a realization event can be held to occur" (App., *infra*, 8a). Accord *Federal Nat'l Mortgage Ass'n* v. *Commissioner*, 896 F.2d 580, 583 (D.C. Cir. 1990).[12]

[11] This language dates back to the regulations under the Revenue Act of 1934. See Treas. Reg. 86, Art. 111-1.

Although the court below upheld the longstanding position reflected in Treas. Reg. § 1.1001-1(a) that a loss can be realized on an exchange only if the properties are "materially different," the court proceeded to eviscerate that requirement by construing the phrase "materially different" so narrowly as to render the term "materially" essentially meaningless. The court held (see *San Antonio*, 887 F.2d at 587-592) that loans that satisfy the Memorandum R-49 criteria are "materially different" merely because the loans have different borrowers and are secured by different collateral. The court gave no satisfactory explanation, however, for why these differences should be regarded as "material." It seems clear that a materiality requirement, at a minimum, means that the difference must actually matter to somebody. Compare *Kungys* v. *United States*, 485 U.S. 759, 770-771 (1988) (the term "material" in the criminal and naturalization context means having "a natural tendency to influence [a] decision"). But it is undisputed here that the differences (in individual borrowers and property secured by the mortgages) on which the court be-

[12] Similarly, a taxpayer cannot be said to have sustained a loss deductible under Section 165 by virtue of a transaction that lacks economic substance. Treas. Reg. § 1.165-1(b) provides in part: "Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss." See generally *Cottage Savings Ass'n* v. *Commissioner*, 890 F.2d at 854-855; see also *Horne* v. *Commissioner*, 5 T.C. 250 (1945) (no deduction allowed where taxpayer sold his seat on commodity exchange at a loss within a month of purchasing another seat); *Shoenberg* v. *Commissioner*, 30 B.T.A. 659 (1934) (no loss allowed where taxpayer sold devalued stock and his wholly-owned corporation simultaneously purchased identical stock), aff'd, 77 F.2d 446 (8th Cir.), cert. denied, 296 U.S. 586 (1935).

low relied did *not* matter to any of the interested parties—respondent, its trading partner, the secondary mortgage market, or the Bank Board, which was the agency charged by Congress with regulating federal savings and loan associations. See App., *infra*, 51a-52a. Thus, the court below effectively held that respondent was entitled to its claimed loss deduction merely because the loans it transferred were not the same in every respect as the loans it received in exchange—without regard to whether those differences were significant. This holding exalts form over substance and severely undermines the efficacy of the realization requirement by allowing differences of no consequence to anyone to be deemed "material," thereby permitting a deductible loss for federal tax purposes to be generated by a transaction that no one regarded as changing the participants' economic position.

The Fifth Circuit suggested in *San Antonio*, 887 F.2d at 589-591, that the differences in individual borrowers and collateral were material because they would tend to make the mortgage loans perform differently over time—*i.e.*, one mortgage loan would turn out to be a worse investment than the other. While it is true that these individual differences could have been expected to yield some disparities in future performance—one borrower might default or one home might decrease in value more than another—it is equally true that the interested parties nonetheless regarded these differences as immaterial. There is no evidence that it would be practical for an exchange participant to attempt to predict future performance based on these differences, and respondent plainly made no effort to assess their significance; it conducted no credit checks on the borrowers or appraisals of the collateral. App., *infra*, 52a. At most, respondent knew that theoretically any one loan might be riskier than another, but neither respondent nor its trading partner attempted to evaluate the

comparative risks or to take any account whatsoever of a possible variance in risk between the loans it was transferring and the loans it was receiving in return.[13] Moreover, the district court also found (*id.* at 52a-53a) that the entire secondary mortgage market, which routinely deals with packages of residential mortgages, similarly regarded as irrelevant differences among individual borrowers and collateral. See also *First Federal Savings & Loan Ass'n* v. *United States*, 694 F. Supp. 230, 245 (W.D. Tex. 1988) ("loans meeting the criteria of Memorandum R-49 are considered economically indistinguishable" by the secondary market), aff'd, 887 F.2d 593 (5th Cir. 1989). Thus, the differences in the exchanged mortgages relied upon by the Fifth Circuit did not affect in any way the nature of the transactions or the decisional process of the parties, and

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[13] Obviously, to the extent an individual loan in the exchanged mortgage pools was riskier than the others, it was correspondingly less valuable (since the terms of the loans in the Memorandum R-49 transactions were identical). Yet respondent and its trading partner did not draw distinctions among individual loans in valuing them; the parties applied a common discount factor to value all of the loans exchanged. This equality of treatment could indicate one of several things: (1) the parties viewed each loan as being equally risky; (2) the parties recognized that there might be disparities in the relative riskiness of similar loans, but they could not tell which loans were riskier, and thus could not take the differences into account in the terms of the exchange; or (3) given the large number of mortgages contained in each pool, risk differences in individual loans were statistically insignificant and did not alter the fact that each *pool* of mortgages was an equally risky investment (see *First Federal Savings & Loan Ass'n* v. *United States*, 694 F. Supp. 230, 245 n.15 (W.D. Tex. 1988), aff'd, 887 F.2d 593 (5th Cir. 1989)). In any event, the differences in the identity of the borrower and the particular property securing the loan simply did not matter to the parties involved in the transactions, and those differences should not be viewed as "material."

they cannot reasonably be characterized as "material" for realization purposes.[14]

The conclusion that the exchanged mortgages were not "materially different" is strongly buttressed by Memorandum R-49 itself. That document represents the considered opinion of the agency then charged by Congress with, *inter alia*, providing rules and regulations for the "examination, operation, and regulation" of federal savings and loan associations. 12 U.S.C. 1464(a). Accordingly, the Bank Board's determination that mortgages that meet the criteria of Memorandum R-49 are "substantially identical" is entitled to considerable respect. See *Ford Motor Credit Co.* v. *Milhollin*, 444 U.S. 555, 566 (1980). While acknowledging that its decision "seems illogical" (*San Antonio*, 887 F.2d at 591), the Fifth Circuit dismissed the Bank Board's opinion as having "no direct relevance" (*ibid.*), stating that " 'substantial identity' " is "a different

[14] The Fifth Circuit stated that the marketplace's opinion that different mortgages were economically indistinguishable was not relevant to the "materially different" inquiry. See *San Antonio*, 887 F.2d at 589-590. This conclusion appears to reject what is generally the most obvious and reliable barometer for assessing whether particular attributes of property are "material" (compare *Emery* v. *Commissioner*, 166 F.2d 27, 29 (2d Cir. 1948) (referring to how the "investing public" viewed the differences between bonds as part of determination that those differences were material); *Hanlin* v. *Commissioner*, 108 F.2d 429, 430 (3d Cir. 1939) (securities are "substantially identical" for purposes of statutory wash sale rule where "differentiations [are] so slight as to be unreflected in the acquisitive and proprietary habits of holders of stocks and securities")) — without offering any alternative point of reference. Moreover, the Fifth Circuit's rejection of a marketplace inquiry is difficult to square with its own statement that "fungible" goods are not materially different. See 887 F.2d at 586. Items are "fungible" if they are identical, but otherwise they can be reliably identified as "fungible" only if the relevant market treats them as fungible — *i.e.*, if the differences between the items are viewed by the market as wholly inconsequential.

concept for a different administrative purpose from the IRS's concept of 'material difference' for tax purposes" (App., *infra*, 8a). This explanation is untenable because the administrative purposes served by the "substantially identical" standard and the "materially different" standard are in fact quite similar.

The purpose of Memorandum R-49, as stated by the Bank Board unit responsible for its promulgation, was to provide a blueprint for a transaction that would not "change the economic position" of the parties to the transaction. See *San Antonio*, 887 F.2d at 580. This characterization was the cornerstone of the Memorandum because a change in economic position would have required the parties to disclose their losses for financial and regulatory purposes — which the parties clearly wanted to avoid, because of the problem of satisfying the Bank Board's minimum net worth and liquidity standards.[15] Similarly, the purpose of the "materially different" requirement for realization in Treas. Reg. § 1.1001-1(a) is to provide that gain or loss is realized only if a taxpayer changes his economic position, *i.e.*, realizes a loss in substance as well as in form. Thus, the two phrases in question are addressed not to "different administrative purpose[s]" (App., *infra*, 8a), but to essentially the same inquiry into economic substance, and the Bank Board's expert opinion that mortgages satisfying the Memorandum R-49 criteria are "sub-

[15] Indeed, were it not for the unwillingness of respondent and the other financial institutions involved in R-49 transactions to report this loss for financial and regulatory purposes, they could have obtained their desired tax losses simply by selling their depreciated mortgage loans for cash. In short, the purpose of the R-49 transactions was to allow the participants to have their cake and eat it too — *i.e.*, to produce paper losses that would be deductible for tax purposes, but that would not have to be reported for any other purpose. See note 2, *supra*.

stantially identical" is highly relevant to the tax question presented here.[16] As the district court concluded in *First Federal* (694 F. Supp. at 245), "it becomes almost ludicrous to suggest that R-49 loans are at the same time 'substantially identical' for financial accounting purposes and 'materially different' for tax accounting purposes when the objective of both systems in this context is to accurately describe economic reality." It is appropriate for this Court to grant certiorari to correct this error by the court of appeals, which has major industry-wide significance and, if allowed to persist, will result in millions of dollars of uncollected taxes.

3. a. The decision below also creates a direct conflict in the circuits on the second question presented—the income tax treatment of early withdrawal penalties received by respondent from its depositors. The court of appeals explicitly acknowledged (App., *infra*, 28a) that its holding that early withdrawal penalties received by a savings institution are excludable from gross income under Section 108 of the Code is irreconcilable with the Seventh Circuit's decision in *Colonial Savings Ass'n* v. *Commissioner*, 854 F.2d 1001 (1988), cert. denied, 109 S. Ct. 1556 (1989).[17]

[16] See *Shoenberg* v. *Commissioner*, 77 F.2d at 449 (where a sale of property "is made as part of a plan whereby substantially identical property is to be reacquired * * * the taxpayer has not actually changed his position"); *Hanlin* v. *Commissioner*, 108 F.2d at 430 (wash sales of "substantially identical" property described as resulting in "the lack of any change in economic position on the part of the taxpayer").

[17] The government opposed the taxpayer's petition for certiorari in *Colonial*, noting that there was no conflict in the circuits. In our brief in opposition, we reported that the instant case was pending in the Fifth Circuit and stated that "[i]f a conflict in the circuits ever does develop on the question presented here, the Court can consider at that time whether certiorari is appropriate in those circumstances." No. 88-1003 Br. in Opp. at 4 n.3.

Both cases involved the tax treatment of a savings institution's receipt of early withdrawal penalties from its customers when they withdrew the principal from fixed-term savings certificates prior to maturity, with the penalties paid by means of an offset against the amounts owed to the customers on the savings certificates. The Seventh Circuit held that early withdrawal penalties are not income from discharge of indebtedness within the meaning of Section 108 and, accordingly, held that the penalties were not excludable from gross income. 854 F.2d at 1004-1007. The court explained that the income "did not arise 'by reason of the discharge of indebtedness.' Rather it arose by reason of the creditor's alteration of the parties' contract and the consequential expenses of the bank/debtor." *Id.* at 1007. The court below, however, "respectfully disagree[d]" (App., *infra*, 9a) with the Seventh Circuit and held that such income does arise by reason of the discharge of indebtedness, and therefore that the income may be excluded from gross income under Section 108. Accordingly, there is a square conflict in the circuits on this issue.

Resolution of this conflict is of considerable administrative importance. Fixed-term savings certificates with early withdrawal penalties are a common method of saving, and therefore the tax treatment of amounts received as penalties is of industry-wide significance. The IRS has advised us that there are pending administratively and in the courts 108 cases involving approximately $128 million in income tax liabilities (excluding interest) that turn on this question. We note, however, that the importance of this issue for future years has been diminished by the 1986 amendment of Section 108 limiting its application to situations in which the taxpayer is insolvent or the discharge of indebtedness occurs in a bankruptcy case. See note 5, *supra*. Thus, for years after 1986, a solvent savings institution can no longer elect under Section 108 to exclude early with-

drawal penalties from its gross income. Because of the volume of litigation and large amount of tax revenue at stake in cases arising in pre-1986 tax years, we nonetheless believe that it is appropriate for this Court also to resolve the circuit conflict on the early withdrawal penalty issue, thereby preventing disparate results in many cases based solely on the geographical location of the taxpayer.

b. The court below erred in permitting respondent to exclude from gross income the amount it received as early withdrawal penalties. It is not disputed that these early withdrawal penalties constitute income to respondent. The question rather is whether they qualify as a particular type of income—realized "by reason of the discharge (in whole or in part) of indebtedness of the taxpayer"—that qualifies for special treatment under Section 108 of the Code. That Section provides generally that such income may be excluded from gross income if the taxpayer elects under Section 1017 to reduce its basis in depreciable property it owns by an amount equal to the amount excluded. The effect of that election is to defer the tax on the debt discharge income; the tax is ultimately collected indirectly because the taxpayer must take lower depreciation deductions for the reduced-basis assets or recognize greater gains on their sale.

It is well established as a general rule that a taxpayer realizes income from the discharge of a debt when the debt is forgiven, cancelled, or otherwise discharged for less than its face amount. See *Commissioner* v. *Jacobson*, 336 U.S. 28, 38-40 (1949); *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931). The predecessor of Section 108 was enacted to provide relief from the *Kirby Lumber* principle for certain debtors. Section 22(b)(9) of the Internal Revenue Code of 1939 (26 U.S.C. (1952)), as enacted by Section 215(a), Revenue Act of 1939, ch. 247, 53 Stat. 875, provided that a corporation "in an unsound financial condi-

tion" could exclude the amount of any income "attributable to the discharge * * * of any indebtedness * * * evidenced by a security," if the corporation elected to reduce its basis in property under Section 113(b)(3) of the 1939 Code (the predecessor of Section 1017). In 1942, Congress broadened the reach of this section by removing the requirement that the corporation be in an "unsound financial condition." See Section 114(a) of the Revenue Act of 1942, ch. 619, 56 Stat. 811. The general purpose of the provision was to facilitate a corporation's ability to strengthen its financial position through retirement of outstanding debt—by allowing deferral of the tax on the resulting debt discharge income (which ordinarily would not produce cash or other assets that could be used to pay the tax). See generally Wright, *Realization of Income Through Cancellations, Modifications, and Bargain Purchases of Indebtedness*, 49 Mich L. Rev. 459 (1951).[18]

It is well settled that income "by reason of the discharge * * * of indebtedness within the meaning of Section 108 is not produced every time a debt is cancelled or discharged. If the cancellation of a debt is not, in and of itself, the source of the income, but simply the method by which a

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[18] The House Report on the 1939 legislation stated as its purpose to aid corporations "whose bonds can be purchased at the present time at less than their face value, giving them an incentive to liquidate their indebtedness." H.R. Rep. No. 855, 76th Cong., 1st Sess. 5 (1939). The Senate Report on the 1942 amendment explained that Congress had determined that limiting the availability of deferral to companies willing to declare their "unsound financial condition" had the effect of "deny[ing] the benefits of this section in many meritorious cases," and stated that removing that restriction "makes it possible for all corporations to have the advantages granted by this section without an impairment of their credit." S. Rep. No. 1631, 77th Cong., 2d Sess. 46, 78 (1942). See also 97 Cong. Rec. 3796 (1951) (statement of Rep. Camp) (provision "removes an impediment to strengthening the financial position of a corporation through debt reduction").

creditor makes a payment to a debtor, then the debtor does not have income "by reason of" a debt discharge; he has income "by reason of" receiving a payment. Such income does not qualify for the Section 108 exclusion. See *OKC Corp.* v. *Commissioner*, 82 T.C. 638, 647-649 (1984); S. Rep. No. 1035, 96th Cong., 2d Sess. 8 n.6 (1980) ("Debt discharge that is only a medium for some other form of payment, such as a gift or salary, is treated as that form of payment rather than under the debt discharge rules."). The court of appeals in this case agreed with this proposition (see App., *infra*, 15a-18a), and it did not take issue with the Seventh Circuit's statement in *Colonial* that "when the discharge of indebtedness is a mere medium for the payment of a separate obligation between two parties, section 108 does not apply" (854 F.2d at 1005). The court below held, however, that this "method of payment" principle is not applicable here because the court did not view the early withdrawal penalty as a "separate obligation." See App., *infra*, 18a-21a. That ruling is erroneous.

Respondent's depositors were bound by federal regulations to pay a penalty to respondent in order to withdraw the principal from one of respondent's fixed-term accounts prior to maturity. See 12 C.F.R. 526.7 (1979); 12 C.F.R. 526.7 (1980); 12 C.F.R. 1204.103 (1981). Respondent collected these penalties by reducing the amount otherwise payable to the depositors. If, instead, the depositors had paid the penalties to respondent in cash and in turn received the entire amount due on the certificates, respondent would have had income in the amount of the penalty and that income clearly would not have been income from the discharge of indebtedness. The result should be no different where, as here, the method of paying the penalty was by reducing the amount turned over to the depositor.[19]

[19] This method of payment was required not by the regulations that imposed the penalties, but rather by the terms of respondent's certificates. See Pltf. Exh. 26.

In short, respondent did not have income "by reason of" the discharge of indebtedness; it had income "by reason of" receiving a penalty. Income from the discharge of indebtedness is realized where a debt is discharged for less than its face amount, *i.e.*, where all or a portion of the debt is forgiven. Here, although the debt owed to a depositor was "discharged" in the sense that it was extinguished, it was not discharged for less than face value. The portion of the debt that respondent did not pay to the depositor was not forgiven by the depositor, but rather was used to satisfy—*i.e.*, to pay—the penalty obligation owed by the depositor. Thus, the Seventh Circuit correctly concluded in *Colonial* (854 F.2d at 1007) that "early withdrawal penalties represent separate obligations from depositors to [savings institutions]," and therefore they are not encompassed within Section 108 of the Code.

The Fifth Circuit's contrary conclusion that the penalty did not represent a separate obligation of the depositor rests primarily upon its observation that the penalty was "an integral part of the CD arrangement" and that "[n]o separate contract created the CD penalty" (App., *infra*, 20a). But the fact that there was but one *contract* between respondent and a depositor does not mean that there was only one *obligation* involving respondent and that depositor. Respondent's obligation to its depositor when he cashed in a savings certificate was typical of the traditional relationship between a debtor-bank and a creditor-customer. The penalty was a distinct obligation owed to respondent by the depositor once he elected to make an early withdrawal. Contrary to the Fifth Circuit's statement (*id.* at 23a), the penalty was not "bargained for as an integral part of the single transaction"; rather, the penalty was imposed from outside the parties' debtor-creditor relationship by federal regulations. Respondent's decision to have that distinct obligation satisfied by reducing its payment

on the certificate—a mere matter of form—should not permit it to achieve a substantial tax benefit under Section 108 by excluding from gross income the amounts it received as early withdrawal penalties.

CONCLUSION

The petition for a writ of certiorari should be granted.
Respectfully submitted.

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JUNE 1990

*The Solicitor General is disqualified in this case.

APPENDIX A

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT

No. 88-1297

CENTENNIAL SAVINGS BANK FSB, PLAINTIFF-APPELLANT,
CROSS-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLEE,
CROSS-APPELLANT

APPEALS FROM THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS

Nov. 2, 1989

Before: BROWN, WILLIAMS and JOLLY, Circuit Judges.

JERRE S. WILLIAMS, Circuit Judge:

Centennial Savings Bank appeals the district court's decision that the bank's exchange of 90% interests in depreciated mortgages with the Federal National Mortgage Association for a separate set of 90% interests in depreciated mortgages did not result in a loss for tax purposes. Centennial also challenges the district court's holding that the statute of limitations did not bar the IRS from assessing taxes owed. On a wholly separate issue the government cross appeals. It claims that the district court incorrectly ruled that income the bank had earned from penalties on

the early withdrawal of certificates of deposit was to be treated for tax purposes as income from the discharge of indebtedness. We uphold the district court's rulings on the statute of limitations and the certificate of deposit issues. We overturn the district court's ruling that the mortgage exchange did not result in a realizable loss.

FACTS AND PRIOR PROCEEDINGS

Centennial Savings Bank ("Centennial") is a savings and loan association regulated by the Federal Home Loan Bank Board (FHLBB).[1] On April 13, 1981, pursuant to the FHLBB's Memorandum R-49 Centennial engaged in a transaction in which it essentially exchanged a package of 90% participation interests in conventional and Federal Housing Administration and Veterans Administration (FHA/VA) mortgages. Centennial made this exchange with the Federal National Mortgage Association (FNMA). The participation interests exchanged were in conventional and FHA/VA mortgage packages having almost identical face and market value.

This transaction was styled "a reciprocal sale". Centennial received mortgage participation interests with a face value of $8,481,263.56. It paid $5,662,044.57 for these participation interests. Similarly, FNMA received participation interests with a face value of $8,481,261.47 from Centennial and paid Centennial $5,662,043.04 for these mortgages. *Centennial Savings Bank FSB v. United States,* 682 F.Supp. 1389, 1391 (N.D.Tex.1988).

Although this transaction is styled as a sale, the mortgages were carefully selected so as to meet the criteria of Memorandum R-49 and the monetary difference in the

[1] Centennial was previously known as First Federal Savings and Loan of Greenville. For purposes of consistency, however, we refer to the bank as Centennial throughout this opinion.

packages ostensibly sold was in fact approximately $2. We have already dealt with the issue of how to characterize a R-49 transaction and found that such a transaction, although characterized as a reciprocal sale, was in fact an exchange. *San Antonio Savings Association v. United States,* __ F.2d __ (5th Cir.1989) ("*SASA*"). We therefore consistently refer to Centennial's R-49 transaction with FNMA as an exchange.

This case comes to us consolidated with two other cases dealing with R-49 transactions, *SASA,* cited immediately above, and *First Federal Savings & Loan Assoc. of Temple v. United States,* __ F.2d __ (5th Cir.1989) ("*Temple*"). Because the details and history of the development of Memorandum R-49 by the FHLBB has already been dealt with in our opinion in *SASA,* we do not repeat that history here. The only significant difference between the facts of this case and those of *SASA* and *Temple* is that Centennial's transaction involved a straight swap of 90% participation interests in home mortgage loans, whereas *SASA* involved a triangular exchange of 90% participation interest, and *Temple* involved a straight swap of complete mortgages. These factual variations are of no consequence. The law as applied in *SASA* and *Temple* applies to these circumstances as well, and we so hold.

Centennial conducted its exchange on April 13, 1981. It then filed for a tax refund and claimed that it sustained a loss of $2,819,218.43. This amount was derived from the difference in the face value of the mortgages it held and the market value which it received from FNMA for the mortgages it received. Centennial filed for the tentative allowance of refund on February 4, 1982, and applied its loss through the carryback mechanism to the taxable years of 1969 through 1980 (1971 excluded). The IRS refunded the tax money Centennial claimed it was owed at that time

from the loss and under the carryback. That amount was $788,633.67.

Also during 1981, Centennial received $258,019 as a result of premature withdrawals of certificates of deposit (CDs), a matter unrelated to the exchange of mortgage participation. Centennial characterized the income received from premature withdrawal of the CDs as income from discharge of indebtedness under § 61(a)(12) of the Internal Revenue Code. The government challenges that characterization, arguing that the money received for early withdrawal of the certificates of deposit constituted gross income.

On September 14, 1983, the IRS informed Centennial that the deduction resulting from the R-49 transaction would be disallowed and the CD penalties must be treated as ordinary income. On December 6, 1984, Centennial executed Form 872, entitled "Consent to Extend the Time to Assess Tax," which extended the time of assessment through December 31, 1985. On June 12, 1985, the IRS issued a notice of deficiency and on November 5, 1985, the IRS made its assessment that Centennial owed the full amount of the refund it had then received pursuant to the loss it claimed from the R-49 transaction.

I. *The Statute of Limitations*

Before dealing with the merits of the lower court's characterization of the R-49 transaction and the CD penalties, we first examine Centennial's claim that the IRS assessment was unenforceable because the statute of limitations had run. Section 6501 of the Code[2] provides the general rule that the statute of limitations as applied to

[2] Throughout this opinion, all sections referred to are within the Internal Revenue Code, 26 U.S.C. § 1 *et seq.* as in force during the applicable years, unless otherwise noted.

tax assessment is ordinarily three years. 26 U.S.C. § 6501(a) (1982). But, in an exception to the three year limit, the taxpayer can consent to later assessment.

> Where, before the expiration the time prescribed in this section for the assessment of any tax imposed by this title, except the estate tax provided in chapter 11, both the Secretary and the taxpayer have consented in writing to its assessment after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

26 U.S.C. § 6501(c)(4) (1982). The dispute in this case concerns the interrelationship between § 6501(c)(4) and § 6501(h), which deals with the period allowing for the assessment of carrybacks.

On December 6, 1984, Centennial's corporate officers signed Form 872, entitled "Consent to Extend the Time to Assess Tax." That agreement stated in part "[t]he amount of any Federal Income tax due on any return(s) made by or for the above taxpayer(s) for the period(s) ended December 31, 1981 may be assessed at any time on or before December 31, 1985."

The district court denied Centennial's motion for summary judgment which asserted that the federal government's assessment of taxes and interest were barred by limitations. *Centennial Savings Bank FSB v. United States*, 670 F.Supp. 195 (N.D.Tex.1987) (order denying summary judgment). Centennial now appeals that ruling on two grounds.

First, Centennial contends that the form it signed constituted a "waiver" rather than an "extension" of the statute of limitations. Centennial cites two Supreme Court

cases as support for this distinction, *Florsheim Bros. Drygoods Co. v. United States,* 280 U.S. 453, 50 S.Ct. 215, 74 L.Ed. 542 (1930) and *Stange v. United States,* 282 U.S. 270, 51 S.Ct. 145, 75 L.Ed. 335 (1931). In both of these cases the Court did conclude that the early analogies of Form 872 were waivers instead of contracts. The courts, however, drew no distinction between waivers and extensions.

Centennial contends that because Form 872 never contained the term "waiver" it constitutes an illegal "extension," which only Congress has the power to grant. This is too slender a semantic thread to support Centennial's argument, particularly since Form 872 parallels the language of § 6501(c)(4), which explicitly allows for assessment after the normal statutory period when both parties consent to it. This language is broad enough to incorporate either the concept of "extension" or "waiver".

Furthermore, this semantic hairsplitting seems at best to create a distinction without a difference. Even if one accepts Centennial's premise that only Congress can "extend" the statute of limitations, nevertheless waiving the ability to raise that defense in effect extends the period of limitations for however long a party contracts not to employ the defense. Whether such an agreement is characterized as a extension or a waiver, Congress has clearly provided for such agreements within the Tax Code. Hence it is not a usurpation of Congress' role for two parties to agree to allow assessment after the normal statute of limitations has run.

Centennial's second contention is that the assessment was barred by the statute of limitations because the assessment was for amounts attributable to the carryback years, 1960-1980 (excluding 1971) while the consent form concerned only tax due for 1981. This argument is in flat contradiction of the plain words of § 6501(h). Section 6501(h)

makes the period of assessment for carryback years coterminous with the limitations period for the year giving rise to the loss.

> In the case of a deficiency attributable to . . . a net operating loss carryback or a capital loss carryback . . . such deficiency may be assessed at any time before the expiration of the period within which a deficiency for the taxable year of the net operating loss or the net capital loss which results in such carryback may be assessed.

26 U.S.C. § 6501(h)(1982). Under this provision when a taxpayer agrees under § 6501(c)(4) that the tax for the loss year may be assessed beyond the normal three year period, he is automatically extending the limitations period for the assessment of that loss as applied to the carryback years.

The taxpayer's only authority for its construction of the code, *Badaracco v. Commissioner,* 464 U.S. 386, 104 S.Ct. 756, 78 L.Ed.2d 549 (1984) does not assist it. *Badaracco* held only generally that the statutes of limitation barring the assessment of taxes are to be narrowly construed to favor the government. *Id.* at 391, 104 S.Ct. at 761. *See also Lucia v. United States,* 474 F.2d 565, 570 (5th Cir.1973). But, the courts addressing this specific issue have held that an agreement to extend the period of assessment for the year in which the loss was incurred also extends the period for assessment for the carryback years. *Nalley v. Ross,* 308 F.Supp. 1388, 1393 (N.D.Ga.1969); *In re Crist,* 85 B.R. 807, 815 (Bankr.N.D.Iowa 1988). *See also, Pesch v. Commissioner,* 78 T.C. 100, 134, n. 57 (1982).

We conclude that the statute of limitations had not yet run when the IRS assessed the tax consequences of the loss claimed on the R-49 transaction for the tax year of 1981. Nor was the statute of limitations applicable to the carryback to the tax years 1969-1980 (excluding 1971).

II. *The R-49 Transaction*

The district court below held that before a loss can be realized on an exchange of items, those items must be materially different. *Centennial,* 682 F.Supp. at 1396-98. The lower court concluded, however, that the mortgages exchanged were not materially different. It came to this conclusion by determining that the mortgages were economic substitutes for each other. *Centennial,* 682 F.Supp. at 1398-1400. We hold today in the related case that a "material difference" is required between exchanged items before a realization event can be held to occur. We also hold, however, that "economic substitutes" can still be "materially different" from each other for tax purposes. *See SASA,* __ F.2d at __. As we stressed in the *SASA* decision, the FHLBB was not deciding the tax implications of its regulatory action. By the same reasoning, the IRS was not empowered to rule on the validity of the FHLBB accounting regulations as automatically implicating specific tax consequences. The test under the FHLBB's R-49 is "substantial identity" of the exchanged property. It is a different concept for a different administrative purpose from the IRS's concept of "material difference" for tax purposes. Tax Court so held, and we affirmed. *SASA,* __ F.2d at __.

We do not need to go into substantial detail as to the differences in the mortgage packages exchanged. It is sufficient to point out that the mortgages Centennial exchanged were generally for less expensive homes located in urban areas in north Texas. The mortgages received were for more expensive properties located throughout the state and primarily in non-urban areas. The average net worth of the mortgagors in the mortgages received was 40% higher than in the mortgages traded off. Also, the later performance of the two mortgage packages differed substantially.

In accordance with our decision of this day in *SASA,* we hold Centennial's R-49 transaction resulted in a realized and recognizable loss for tax purposes because the participation interests exchanged were in mortgages which under the Internal Revenue Code differed materially from each other.

III. *The CD Penalties Received by Centennial were Income from Discharge of Indebtedness Under § 108 of the Code*

The final issue in this case is whether the $258,019 received by Centennial during 1981 for early withdrawals of certificates of deposit (CDs) constituted "income from the discharge of indebtedness" under § 108 and § 1017 of the Code. The district court held that the "penalties" for early withdrawal were indebtedness discharge income. *Centennial,* 682 F.Supp. at 1400-03. The United States Tax Court and the Seventh Circuit have also addressed this issue and held to the contrary in *Colonial Savings Assoc. v. Commissioner,* 85 T.C. 855 (1985), *aff'd* 854 F.2d 1001 (7th Cir. 1988), *cert. denied,* __ U.S. __, 109 S.Ct. 1556, 103 L.Ed.2d 859 (1989). On this issue, we respectfully disagree with the conclusions of the Tax Court and the Seventh Circuit in *Colonial Savings* and affirm the holding of the district court below.

There is no dispute that Centennial received income for purposes of the Internal Revenue Code when it received the early withdrawal penalties from its CD holders. The issue, however, is whether this income, the "penalty" money received for early withdrawal of the CDs, should be characterized as "income from the discharge of indebtedness." Such a characterization of the income would be favorable to Centennial because a taxpayer is permitted to pay the tax on income from the discharge of indebtedness over time via favorable mechanisms rather than immediately. 26 U.S.C. § 1017 (1982 and Supp. IV 1986).

The statutory scheme that gave rise to this question is fairly straightforward. As in force for tax year 1981, § 108 provided that "[g]ross income does not include any amount which (but for this subsection would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if . . . (C) the indebtedness discharged is qualified business indebtedness." 26 U.S.C. § 108(a)(1)(C) (1982). "Qualified business indebtedness" was defined as follows:

> Indebtedness of the taxpayer shall be treated as qualified business indebtedness if (and only if)–
>
> (A) the indebtedness was incurred or assumed–
>
> (i) by a corporation, or
>
> (ii) by an individual in connection with property used in his trade or business, and
>
> (B) such taxpayer makes an election under this paragraph with respect to such indebtedness.

26 U.S.C. § 108(d)(4) (1982). Section 108(c) then allowed a corporation to reduce the adjusted basis of his depreciable assets under § 1017 by the amount of the qualified business indebtedness.[3]

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[3] All three of these provisions of § 108 were the result of a 1980 Act which completely overhauled § 108. Bankruptcy Tax Act of 1980, Pub.L. 96-589, § 2(a), 94 Stat. 3389, 3389-94. These provisions were incorporated without change into the 1982 version of the official code. Hence, although the relevant tax year is 1981, we cite here to the 1982 code.

Furthermore, all three of these provisions have now been struck from the Code. Tax Reform Act of 1986, Pub.L. 99-514, § 822(a), (b)(2), (b)(3)(A), 100 Stat. 2085, 2373. Because we are dealing with the law applicable to taxation of income in 1981, however, the subsequent amendment is irrelevant to this case.

The principle that a taxpayer can realize income from the discharge of indebtedness was first established in *United States v. Kirby Lumber Co.*, 284 U.S. 1, 52 S.Ct. 4, 76 L.Ed.2d 131 (1931). In *Kirby Lumber*, a corporation retired some of its own bonds by purchasing them at a price less than the face value it had received for them when issued. The Supreme Court found that the excess of the issuing price over the purchase price constituted an accession to income. The Court characterized the income as income from the discharge of indebtedness.

According to Centennial, when the depositor purchased a CD at a bank, the bank incurred a debt toward that depositor. Under the terms of the CD, Centennial was obligated to repay the depositor's principal plus interest that had accrued at a fixed rate at an agreed future date. If the depositor withdrew his or her money before the end of the term, he or she was assessed a "penalty" for the early receipt of that money.[4] That penalty was predetermined by federal law. 12 C.F.R. § 1204.103 (1981); 12 C.F.R. § 526.7 (1980). Because Centennial characterized its relationship with holders of CDs as one of indebtedness, it treated the penalties assessed on the early withdrawal of CDs as "income from the discharge of indebtedness." The IRS argues instead that the penalty assessed for early withdrawal of a CD does not constitute income from the discharge of indebtedness, but is analogous to damages for breach of contract.[5]

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[4] The actual mechanics of such transactions do not result in the payment of a "penalty" by the CD holders. Centennial paid back the CD holders the principal and interest accrued to that point, minus the amount forfeited due to early withdrawal. Hence, technically no CD holders ever *paid* a "penalty" to Centennial – they merely received less money than they would have received if the accrued interest had been paid and the penalty had not been assessed.

[5] Much has been made by the parties of the semantics of characterizing the difference between the principal and amount of in-

The general rule is that the characterization of income as income from the discharge of indebtedness depends purely on the spread between the amount received by the debtor and the amount paid by him to satisfy his obligation. 1 Bittker and Lokken *Federal Taxation of Income, Estates and Gifts*, ¶ 6.4.2 (2nd Ed.1989). *See also* Bittker and Thompson, *Income from the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber Co.*, 66 Calif.L.Rev. 1159, 1166 (1978).[6] Under this general rule Centennial's CD penalties were income from the discharge of indebtedness.

The general rule's focus on the final result has the aura of authenticity. As the Seventh Circuit conceded, one of the strengths of the savings institutions' argument is that "[a]fter all, whether the penalty is paid out of the funds in the bank's custody or by the depositor's funds from other sources, the effect of the penalty is to ensure that Colonial's net obligation to its depositor is far less than it would otherwise have been." *Colonial Savings*, 854 F.2d at 1006.

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terest accrued (the amount owed) and the amount actually paid. Centennial argues that this amount is a "forfeiture" while the IRS calls it a "penalty." We attach little import to the use of these different terms. While through-out this opinion we refer to the difference in the amount paid and the amount representing the principal and interest accrued as the "penalty," we do so only for conciseness. It is easier to say "the penalty" than to have to refer continually to "the difference between the amount representing accrued interest and original deposited principal and the amount actually paid." We do not by use of the term imply that the IRS is correct in characterizing the "penalty" as not constituting part of a discharge of debt transaction.

[6] Bittker notes a number of exceptions to this general rule involving the nature of the debt. Bittker and Lokken, ¶ 6.4.2. None of these, however, are applicable to the case before us.

Bittker's application of *Kirby Lumber* involves financial adjustment purely for gain or to minimize loss.

> The classic case for the application of the *Kirby Lumber* principle is a financial adjustment in which a creditor accepts less than the full amount of the debt in full payment, either because of doubts about the debtor's ability to pay in full or because a rise in the interest rate for comparable loans has made the old debt worth less than its face amount.

Bittker and Thompson, 66 Calif.L.Rev. at 1174. In the case before us, the individual CD holders may have withdrawn their deposits for a number of reasons, including the possibility that the going market interest rate may have risen and made it more profitable to withdraw the CD funds and deposit them elsewhere. This scenario perfectly fits the classic characterization of debt discharge income. It is true that some CD owners may have withdrawn their deposits early for unanticipated personal reasons rather than the purely economic motives posited in Bittker's scenario. Regardless of their motivation, however, the end result was the same; the CD holders withdrew the money because they believed they could put it to better use elsewhere. In turn, Centennial discharged its debt for less than its accrued obligation.

A. *Prior History and Purpose of § 108*

The government in arguing that the CD penalties do not qualify as § 108 debt discharge income urges several grounds that were relied upon by the Tax Court and Seventh Circuit in *Colonial Savings*, 85 T.C. 855, *aff'd* 854 F.2d 1001. The first of these arguments is that § 108 was not intended to apply to debt discharge income of solvent, financially liquid companies. While § 108 was certainly originally intended to help financially troubled taxpayers,

at the time applicable to this case it was not limited to such taxpayers. Hence we conclude that *Centennial* is not barred from the benefits of § 108 and § 1017, even if it was not financially troubled.

Often indebtedness is discharged to a company having financial difficulties. The creditor's purpose in discounting such a company's debt is to trade the right to full payment for swifter and more certain payment of a lesser portion of the debt. This sort of debt discharge produces income in the debtor's books due to a lowering of liabilities, but it does not leave the debtor with more cash in hand with which to pay taxes. It was because of these concerns, that Congress originally enacted the predecessor to § 108, § 22(b)(9) of the Internal Revenue Code of 1939. Revenue Act of 1939, ch. 247, § 215(a), 53 Stat. 863, 875. Thus, Section 22(b)(9) provided that a corporation could exclude the amount of a discharge of indebtedness from its gross income if the corporation was in an "unsound financial condition".

But, in 1942, Congress removed the requirement that the corporation be in an "unsound financial condition". Revenue Act of 1942, ch. 619, § 114(a), 56 Stat. 798, 811. It is not entirely clear why the requirement was removed, but there is no question but that the amendment constituted a significant broadening of the provision. The Senate Committee which proposed its removal merely stated that its amendment relaxed "the standard established in 1939 and makes it possible for *all* corporations to have the advantages granted by this section without an impairment of their credit." (emphasis added) S.REP No. 1631, 77th Cong., 2nd Sess. § 114 (1942), 1942-2 C.B. 504, 564.

Finally, in 1986, Congress came full circle and eliminated the "qualified business indebtedness" provision from § 108, so that now only discharge of indebtedness

income occurring in a bankruptcy case or when the taxpayer is insolvent is excluded from gross income by § 108 and qualifies for the "spreading" provision of § 1017. Tax Reform Act of 1986, Pub.L. 99-514, § 822(a), 100 Stat. 2085, 2373 (codified as amended at 26 U.S.C. § 108(a) (Supp. IV. 1986)). Whatever may have been Congress' initial purpose in exempting debt discharge income from an immediate taxation, however, there was no requirement of financial inability to pay tax on that income between the years of 1942 and 1986, the critical year in this case being 1981.

The Tax Court in *Colonial Savings* noted the elimination of the requirement of unsound financial condition but then failed to credit it, claiming that § 108 and its predecessors were only intended to apply to situations in which assets were "trapped" and not liquid. *Colonial Savings,* 85 T.C. at 863-64. The tax court relied on *Estate of Delman v. Commissioner,* 73 T.C. 15 (1979) in drawing its conclusion. *Delman* does not, however, deal with an instance of income from discharge of indebtedness, nor does it interpret § 108 (in it's pre-1986 form) to require insolvency. *Delman,* 73 T.C. at 39-40, n. 19. The district court in the instant case correctly rejected this Tax Court analysis in *Colonial Savings* because the Tax Court failed to take into account Congress' removal of the unsound financial condition requirement. *Centennial,* 682 F.Supp. at 1402.

B. *Spurious v. Genuine Discharge of Indebtedness*

The government next argues that the debt discharge is not "genuine" § 108 debt discharge but represents a "spurious" debt discharge. This phrase was employed by Professor Bittker in the often quoted, previously cited, article. *See* Bittker and Thompson, 66 Calif.L.Rev. at 1174. Two broad characteristics of spurious cancellation of in-

debtedness outlined by Professor Bittker are (1) the debt is not discharged for less than its full amount, but is paid in full indirectly and (2) the debt is cancelled "not to effect a financial adjustment of the debtor-creditor relationship but as an indirect way of achieving a much different objective." 1 Bittker and Lokken, *Federal Taxation of Income, Estates and Gifts,* ¶ 6.4.4 (2nd Ed.1989).

A widely used example of a spurious cancellation of debt occurs when an employer "loans" an employee $50 with the understanding that it will be deducted from the employee's next paycheck. The next pay day no cash changes hands, the transaction is formally termed a "cancellation" but nevertheless the debt is paid in full. The employee must report the $50 as regular income, not as income from the discharge of indebtedness within the meaning of § 108 or *Kirby Lumber.* Bittker and Thompson, 66 Calif.L.Rev. at 1174. In this situation the employee did not gain nor did the employer lose income through the discharge of debt. The employer received work equal in value to the money which it paid; the employee conversely earned his wage. The only difference between this arrangement and the ordinary circumstance is that the employee received his payment ahead of time with the understanding that he would not receive that portion of his wage on pay day. Cancellation of indebtedness occurred in this example, but neither party received income as a result of the transaction.

It is important to note what was and was not spurious in the example above. The debt discharge itself was not spurious, because the debt was truly and effectively cancelled. What would be spurious would be "the implication that the debt was discharged for less than its face amount." Bittker and Lokken, ¶ 6.4.1, n. 23.

The spurious versus genuine debt discharge distinction is upheld by cases which deal with § 108 and its statutory

predecessors. Genuine discharge of indebtedness is held to have occurred in cases where creditors accepted less than full value for the amounts which were owed in return for the benefit of early payment. Such a case of genuine debt discharge in *Reliable Incubator and Brooder Co. v. Commissioner,* 6 T.C. 919, 926-27 (1946). In that case, the taxpayer-debtor had a debt of $6,700 upon which he was obligated to make $50 monthly payments. His creditor needed funds, so the parties agreed to reduce the outstanding debt by $1,200 in exchange for an advance payment of $600. The Tax Court determined that the taxpayer-debtor received $600 discharge of indebtedness income.[7] *See also San Marcos Hotel Co. v. Commissioner,* 11 T.C.M. 388, 392-93 (1952), *aff'd,* 205 F.2d 641 (9th Cir.1953).

In cases of spurious debt discharge, the debt discharge is often described as merely the "medium of payment" for an obviously separate obligation between two parties. *Colonial Savings,* 854 F.2d at 1005. Two clarifying examples of use of debt discharge as a mere medium of payment are *Spartan Petroleum Co. v. United States,* 437 F.Supp. 733 (D.S.C.1977) and *OKC Corp. v. Commissioner,* 82 T.C. 638 (1984). Spartan Petroleum Company was a gasoline distributor, which was $233,174.73 in debt to its franchiser, Atlantic Richfield Company (ARCO). ARCO sought to cancel its franchise agreement with the Spartan. The two parties agreed that ARCO would pay over $1 million in damages for that cancellation. ARCO agreed, however, to subtract Spartan's debt from its damages payment, rather than pay the full amount and then require Spartan to repay separately its debt to ARCO. Spartan

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[7] The taxpayer was not, however, allowed to exclude the income as debt discharge from its gross income because the transaction occurred prior to 1942 at the time when the law required the taxpayer to be in "unsound financial condition."

characterized this cancellation as giving rise to § 108 debt discharge income. The district court concluded, however, that the cancellation of indebtedness was not a § 108 discharge because the "foregiveness of the indebtedness" was in fact part of the payment to the distributor for cancellation of the franchise agreements. Similarly, in *OKC* Phillips Petroleum agreed to cancel a debt of OKC's in return for OKC's agreement to release Phillips from an unprofitable output contract.

In each of these cases, the creditor did not discharge the debtor of part or all of his obligation. The creditor had his loan entirely repaid by the receipt of something valuable from the debtor, and the cancellation of the debt was merely the creditor's method of payment. In contrast, in *Reliable Incubator* the creditor discharged a portion of the debt for the direct purpose of receiving payment of the remaining debt more quickly. Thus, two factors distinguish *Reliable Incubator* from *Spartan*. (1) The thing received—faster payment of outstanding debt—was only in the context of the debtor/creditor relationship. In both *Spartan Petroleum* and *OKC Corporation* on the other hand the debt was cancelled as payment for an entirely different item or right of material worth outside the debtor/creditor relationship. (2) In *Reliable Incubator*, after all the dust had settled, the creditor did not get the full value of the loan back, whereas in *OKC* and *Spartan* they did.

Thus, only genuine or "pure" debt discharge income falls within the ambit of § 108. We must now examine, therefore, whether Centennial's CD penalties are more like the income received in *Reliable Incubator* or that which occurred in *Spartan*.

1. *The CD Penalty as Payment of a Separate Obligation*

The Tax Court endorsed the IRS's view that when a CD holder received less money back than he otherwise would

because of the penalty for early withdrawal, that forfeiture did not result in § "108 debt discharge" income. The Tax Court views the penalty essentially as liquidated damages for breach of contract by early withdrawal of the deposits, rather than pure debt discharge. Hence the penalty was merely a medium for payment of a separate obligation. *See Colonial Savings*, 85 T.C. at 866-67.

> We hold that the forfeiture in this case is not a discharge of indebtedness within the meaning of the statutes and *United States v. Kirby Lumber Co., supra,* and its progeny. As more fully discussed in the foregoing opinion, we find that the forfeiture was a separate and distinct obligation required of depositors for early withdrawal and not a forgiveness or discharge of the debt. The debt to the depositor was not cancelled or discharged, it was simply reduced.

Colonial Savings, 85 T.C. at 861.[8]

We cannot accept the government's claim that the CD penalty was a separate obligation, independent from the debtor/creditor relationship existing between the bank and the depositor have. The penalty was not assessed as

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[8] We fail to understand the distinction which the Tax Court makes between cancellation or discharge of debt on the one hand and "debt reduction" on the other hand. Debt reduction was the *means* by which both the creditor in *Reliable Incubator* and *Centennial* each discharged part of their creditor's debts.

If a bank loans an architect $25,000 and then accepts $10,000 worth of the architect's services as fully extinguishing the $25,000 debt, $15,000 of the debt was "discharged" and $10,000 of the debt wa paid in full. Bittker and Lokken, ¶ 6.4.4. This transaction can be described equally well as a "debt reduction" or discharge of part of the debt and payment in full of the rest. Hence the issue is not whether "debt discharge" or "debt reduction" occurred, but rather whether the creditor genuinely received less than the full value of his loan in complete satisfaction of the debtor's debt.

the result of a separate relationship. It was an integral part of the CD arrangement, a requirement delineated prior to the purchase of CD. No separate contract created the CD penalty, and in fact the penalty was an integral part of the CD obligation. The legal nature of a Certificate of Deposit is controlling. Part of a CD's function is to act as hedge against a fall or an increase in interest rates. When the bank sells the creditor/depositor a CD, the bank is then obligated to pay the owner of the CD a fixed interest rate for a set period of time. If the market interest rate falls during that period of time, even precipitously, the bank must still continue to pay the CD holder that set interest rate. On the other hand, if the market interest rate rises significantly after the depositor has purchased his CD the bank will still need to pay no more than the fixed rate. In such circumstances the bank gets the use of the CD owner's money cheaply during a period of expensive money. If the CD owner could simply withdraw his money whenever the market interest rates rose above the agreed upon amount, there would be no point in having a CD arrangement (at least from the banker's point of view).

The early withdrawal penalties allow the CD owner to buy the early termination of his agreement to leave his money in for a given period of time at a set interest rate. Because the contract is purely one of debt and credit, the penalty provision creates pure debt discharge and it adds nothing to say it is liquidated damages for breach of contract.

The payment of Centennial's CD penalty is not an obligation independent of the creditor/debtor relationship, as were the damages in *Spartan*. What makes this case different from *Spartan* is the nature of the penalty. The penalty clause is actually nothing more than a common business arrangement which is the very basis of the CD as a financial device. The early withdrawal, pragmatically, is not a breach of contract. It is simply a right to end the contract at an earlier time by a discount of the face value at maturity.

The fact that this particular debt discharge is required by federal regulations does not change the ultimate result—if the creditor claims his money early he reduces the amount of the debtor's obligation. Further, the change in the code in 1986 that now makes the receipt of such penalties a part of gross income does not change the routine nature of the transaction. It only changes the tax consequences, as of course the government has full power to do.

2. *The Two-Step v. One-Step Distinction*

The government claims that the CD penalties are properly analyzed as a two-step transaction, albeit a hidden two-step transaction of the sort involved in *Spartan Petroleum*. According to the government if the depositor had paid the penalty in cash, and in turn received the entire amount due on the account, then the bank-taxpayer would have had income in the amount of the penalty. That income, however, would not have been income from the discharge of indebtedness because in the posited example there was no discharge of a debt for less than its face amount. The source of income was simply from the receipt of a penalty.

This "two transaction versus one transaction" analysis misapplies the law and elevates form over substance. In *Spartan* a debt was forgiven as a means of payment for breach of an entirely separate contract. The purpose of the debt forgiveness was to fulfill two different obligations in one action. The same effect would have been achieved if the debtor had paid the creditor the amount of money owed and then the creditor had paid the debtor for the

breach of the separate dealership contract. Instead the parties agreed that the two obligations cancelled each other out. Such a transaction involving two completely separate relationships and obligations between the parties can properly be characterized as a two-step transaction hidden in a one-step transaction.

The critical question, however, is whether the debtor ultimately fully repays his debt, whatever the form of that repayment. Any pure debt discharge transaction could be characterized as taking two steps. A § 108 discharge of indebtedness would arise if a lender loaned $1,000 to a retail businessman but provided in the loan agreement that if the debtor encountered financial trouble (measured by, for example, a drop in sales of "x" units per month over a defined number of months) the required repayment on the debt would be reduced to $800. Under the government's analysis, such a loan agreement unrealistically would create a "separate obligation" on the creditor to pay $200 to the retail business if financial trouble occurred and the debtor would be conceived of as repaying his lender the full $1,000 after which the lender simply contributes $200 to assist the troubled business.

In accordance with our analysis, however, we focus upon the result. The result would be that the debtor paid $800 in complete discharge of his $1,000 debt. Thus, he received $200 in income through debt discharge. Hence, we conclude that this claim by the IRS fails to demonstrate that CD penalties are spurious debt discharges.

3. *Aberrations from Normal § 108 Debt Discharge Form*

The IRS next contends that the CD penalties exhibit aberrations from ordinary § 108 debt discharge patterns because normal § 108 debt discharge cases are the result of negotiation. It is true that debt discharge is often ad hoc,

arising from the changed circumstances of the debtor rather than prearranged contractually. There is no reason, however, that debt discharge cannot be prearranged contractually.

Furthermore, the fact that the creditor rather than the debtor initiates the CD withdrawal is of no consequence. Both the courts and the Internal Revenue Service agree that an individual homeowner/debtor realizes income from partial discharge of his home mortgage debt if he agrees to prepay his loan at a discount to his lender. S & Ls and banks frequently offer their mortgagors this prepayment opportunity in order to permit the creditor S & L or bank to profit by reloaning the mortgage money at higher interest rates. *See Sutphin v. United States*, 14 Cl.Ct. 545 (1988); *Michaels v. Commissioner*, 87 T.C. 1412 (1986); Rev.Rul. 82-202, 1982-2 C.B. 36. In such cases the creditor initiates the transaction by offering the terms of debt reduction. But the government argues that this situation is distinguishable because the amount of debt forgiveness was the result of bargaining between the parties. We do not find this bargaining requirement persuasive. It is not in the Code, and in any event the penalty was bargained for as an integral part of the single transaction.

A related argument involves the Tax Court's method of distinguishing *Reliable Incubator*.

> Petitioner here [Colonial Savings] was in debt for interest (and principal) and part or all of its indebtedness was "paid" or offset by the depositors' obligation for a penalty attributable to premature withdrawal. Stated another way, the debtor's accumulated interest was essentially used to pay the penalty on a dollar-for-dollar or par basis. The parties in *Reliable Incubator* entered into a "two-for-one" reduction in indebtedness so that each dollar paid provided an additional "dollar of forgiveness" of the debt. Only the

> additional dollar or credit (the "forgiveness dollar") was found to be income from discharge of indebtedness.

Colonial Savings, 85 T.C. at 868. We fail to perceive the difference in facts that the Tax Court does. In *Reliable Incubator*, the creditor wished to receive part of the debt more quickly, and in exchange for this benefit agreed to reduce the debtor's obligation. Here the depositors wish to receive the money for their CD's back from the bank ahead of schedule, and therefore agreed to a reduction in the amount *Centennial* owed them in exchange for that benefit. Whether this is characterized as essentially two-for-one or one-for-one does not matter. In both cases the creditor gave up his rights to a part of the debt in order to receive the rest of debt more quickly. We find no justification in the Code for a conclusion that the amount given up to the amount of debt paid off matters for tax purposes.

C. *Revenue Ruling 73-511*

The Seventh Circuit in *Colonial Savings* affirmed the Tax Court, but emphasized different reasoning from the IRS in its decision. Rather than relying on the spurious versus genuine debt discharge distinction, the Seventh Circuit based its determination upon the conclusion which it drew from Revenue Ruling 73-511 that a withdrawal penalty is not a § 108 debt discharge. *Colonial Savings*, 854 F.2d at 1006-07. The ruling says:

> There is no statutory provision for the use of any type of netting rule since the interest paid or credited and the forfeiture incurred represent two separate transactions and are taxable as such. Interest paid to the depositor or credited to his account with no restriction as to withdrawal is includible in his gross income in accordance with his accounting method. This [sic]

> only relationship between the interest and the forfeiture penalty is the fact that the penalty is calculated by references to a given amount of interest. . . .
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> . . . .
>
> Also, while the gross amount of interest paid or credited to the depositor must be included in the depositor's gross income, in the case of an individual depositor, the forfeiture, allowable as a loss under section 165(a) of the Code, would generally be considered as a loss incurred in a transaction entered into for profit, as described in section 165(c)(2), and may be claimed in the year of the forfeiture only if the taxpayer itemizes his deductions. However, if the deposit arrangement is entered into as part of the individual taxpayer's trade or business, the forfeiture would be a loss incurred in a trade or business, as described in section 165(c)(1), and would be deductible in the year of forfeiture in arriving at adjusted gross income. All other taxpayers would claim a loss under section 165(a) in the year of the forfeiture.

Rev.Rul. 73-511, 1973-2 C.B. 402.

We conclude that the Seventh Circuit read too much into Revenue Ruling 73-511. The crucial language, "the interest paid or credited and the forfeiture incurred represent two separate transactions" is somewhat ambiguous. Indebtedness always involves two types of transactions, the periodic payment or accrual of interest and the retirement of the indebtedness. While these are clearly two separate transactions, the Ruling does not explicitly state whether the payment of the aggregate of the principal and accrued interest at early retirement of a CD is a separate transaction from the forfeiture of a portion of such principal and accrued interest on early retirement.

Assuming that Revenue Ruling 73-511 is read to address the relationship between the payment of principal and accrued interest and the early withdrawal penalty at retirement of the CD, we still do not find the Revenue Ruling controlling because it only addresses the mechanics of forfeiture and accrual of interest rather than the underlying relationship. It says that the penalty and interest payment are two separate transactions, but never says that two separate *obligations* are involved. As noted above, the forfeiture provision is integral to the CD arrangement. Revenue Ruling 73-511 does not characterize the payment of interest and principal on the one hand and the forfeiture of the early withdrawal penalty on the other hand as created by two separate agreements or obligations.

We assume that for accounting purposes the discharge of a debt at a reduced rate constitutes two transactions in order to assess the amount lost by the creditor and gained by the debtor on the debt discharge. In the case of the CD withdrawals at issue, only one transaction actually occurred but we agree that the mechanics of the transaction should not control here. The controlling conditions to establish the discounted "penalty" as income must be: (1) the debt discharge occurred purely in the context of the debtor/creditor relationship as opposed to advancing a separate relationship or goal, and (2) the debt was ultimately fully discharged. In the case of these CDs both of these conditions were met.

The Seventh Circuit concluded that early withdrawal penalties are "sufficiently different" from the usual § 108 debt discharges that "Congress can be expected to have addressed specifically any special tax consequences surrounding [their] use." *Colonial Savings*, 854 F.2d at 1007. Congress did address Revenue Ruling 73-511. The Ruling only allowed deduction of early withdrawal penalties from gross income by those who itemized their deductions.

Congress sought to soften the blow of the Revenue Ruling by allowing non-itemizers to deduct early withdrawal penalties from gross income. Pub.L. No. 93-483, § 6(a), 88 Stat. 1457, 1458-59 (1974). This congressional response is currently codified at 26 U.S.C. § 62(a)(9).

> (a) General Rule—For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions: . . . .
>
> (9) Penalties forfeited because of premature withdrawal of funds from time savings accounts or deposits—The deductions allowed by section 165 for losses incurred in any transaction entered into for profit, though not connected with a trade or business to the extent that such losses include amounts forfeited to a bank, mutual savings bank, savings and loan association, building and loan association, corporative bank or homestead association as a penalty for premature withdrawal of funds from a time savings account, certificate of deposit, or a similar class of deposit.

26 U.S.C. § 62(a)(9) (Supp. IV 1986). If the interest was included in gross income, the early withdrawal penalty was then subtracted from gross income, and the end result was just as if the netting rule was in force. This provision negates the IRS's determination that there was no "netting rule" allowing only the interest credited under a CD minus the early withdrawal penalty to be included in gross income.

Congress never, however, directly addressed the issue of whether early withdrawal penalties were to be considered income from debt discharge or not. The Seventh Circuit held that

> [N]othing in this legislation or in its legislative history expresses disapproval of the revenue rulings' conclu-

> sion that interest income and early withdrawal penalties are separate and distinct obligations, and that interest income and penalties cannot be set off for income tax purposes.

Colonial Savings, 854 F.2d at 1007. We do not find the Congressional reaction to Revenue Ruling 73-511 dispositive, as does the Seventh Circuit. The failure to discuss whether early withdrawal penalties equal § 108 debt discharge income is not unreasonable, given the fact that Revenue Ruling 73-511 itself never directly addresses the issue. We therefore do not interpret the Congressional silence on this issue as endorsing the IRS's current treatment of early withdrawal penalties as not being income from debt discharge under § 108.

The issue of what constitutes debt discharge for purposes of § 108 is admittedly difficult and many of the questions raise evenly balance considerations.[9] We recognize that we are taking a position in opposition to the Internal Revenue Service, the Tax Court, and the Seventh Circuit. We nevertheless conclude that income from early withdrawal penalties of CDs can properly be classified as income from the discharge of indebtedness under the doctrine of *Kirby Lumber* and for purposes of § 108. We conclude that the so-called "penalty" for early withdrawal under the code as it then existed created income to the bank-debtor in the nature of a discharge of indebtedness. The fact that Congress has now decided to change the statute to treat the income as part of gross income does not change the dictates of the code as it existed and was applicable to the transactions here involved.

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[9] Discharge of indebtedness cases and the technical distinctions in this area have been described as "[o]ne of the murkiest pools of obscurity in the tax law for the past three decades. . . ." *See* Hugh, *Cancellation of Indebtedness and the Federal Income Taxes: The problem of creeping confusion,* 14 Tax.L. Rev. 225 (1959).

Conclusion

We uphold the district court's determination that the IRS's assessment was not barred by the statute of limitations and that the money Centennial received from early withdrawal penalties from certificate of deposits was income by way of debt discharge under § 108. We also uphold the district court's determination that a material difference is required between two exchanged items before gain or loss can be realized, but in accordance with the companion cases decided this day, we reverse the district court and find that the mortgage participation interests exchanged and received by Centennial were materially different under the Internal Revenue Code.

AFFIRMED IN PART; REVERSED AND RENDERED IN PART.

APPENDIX B

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

No. CA3-86-1396-H

CENTENNIAL SAVINGS BANK FSB, PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

[Filed Jan. 22, 1988]

MEMORANDUM OPINION AND ORDER

In this nonjury case Plaintiff, Centennial Savings Bank FSB ("Centennial"), sues Defendant, United States of America ("government"), to recover federal income taxes collected from Centennial.

The case involves two discrete issues affecting Centennial's federal income tax liability for the years 1969-1981 (1971 excluded). The first relates to the tax consequences to Centennial of Mortgage Participation Sale Agreements entered into and consummated with the Federal National Mortgage Association ("FNMA") in 1981; the second concerns the tax liability to Centennial of premature withdrawal penalties on certificates of deposit collected by Centennial in 1981 from its depositors. Although a net operating loss was reported by Centennial in 1981 as a result, in part, of both the alleged losses incurred due to

the mortgage transaction and attempted deferral of income received from the premature withdrawal penalties on certificates of deposit, the issues surrounding each matter are different, and will be discussed separately.

The Court has jurisdiction and venue by virtue of 28 U.S.C. §§ 1340, 1346, and 1402(a)(2).

I. THE MORTGAGE TRANSACTIONS

A. *Factual Background*

Centennial, formerly known as First Federal Savings and Loan of Greenville, is a Texas corporation with its principal place of business in Greenville, Texas. It is a federally insured mutual savings and loan association chartered under the Home Owner's Loan Act of 1933 and subject to review, supervision and regulation by the Federal Home Loan Bank Board ("Bank Board") and Federal Savings and Loan Insurance Corporation ("FSLIC").

In 1981, Centennial's mortgage loan portfolio was composed of whole mortgages on residential property, including conventional, Federal Housing Administration ("FHA"), and Veterans Administration ("VA") mortgages, which had been purchased in part from, and were still serviced by, Southern Trust and Mortgage Company ("STM"). The portfolio was comprised primarily of fixed-rate, long-term mortgage loans which had been issued in the late 1960s at interest rates significantly lower than those charged on more recent loans. The high market interest rates of the late 1970s and early 1980s precluded disposition of these low interest rate loans at their face value; if the loans were sold, the savings and loan association would receive much less than their face value. At the same time, the profits and cash flow of savings and loan institutions were adversely affected by having to offer higher interest rates on deposits to attract funds for

deposit. It became increasingly difficult for savings and loans like Centennial to maintain capital reserves and minimum liquidity ratios imposed by the Bank Board. An examination of Centennial's financial position in February, 1982 by the Bank Board showed that Centennial had an operating deficit of $309,801 for the fiscal year ending December 31, 1981 and a projected deficit in operating results of $471,000 for the six-month period January 1 through June 30, 1982. The principal reason for the deficit was Centennial's high cost of money.

Prior to 1980, savings and loan institutions were required by the Bank Board to record for financial and regulatory purposes any losses resulting from mortgage sales. On June 27, 1980, the Bank Board issued Memorandum R-49 ("R-49"), a regulatory accounting principle, which sets forth criteria that a savings and loan association would have to comply with if it wanted to "reciprocally" sell mortgage loans and not recognize or record for financial and regulatory purposes any loss resulting therefrom. R-49 (Government Exhibit 8) reads as follows:

> The purpose of this memorandum is to advise OES staff on the proper accounting for reciprocal sales of mortgage loans.
>
> A loss resulting from a difference between market value and book value in connection with reciprocal sales of substantially identical mortgage loans need not be recorded. Mortgage loans are considered substantially identical only when each of the following criteria is met. The loans involved must:
>
> 1. involve single-family residential mortgages,
> 2. be of similar type (e.g., conventionals for conventionals),
> 3. have the same stated terms to maturity (e.g. 30 years),

> 4. have identical stated interest rates,
> 5. have similar seasoning (i.e., remaining terms to maturity),
> 6. have aggregate principal amounts within the lesser of 2½% or $100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,
> 7. be sold without recourse,
> 8. have similar fair market values,
> 9. have similar loan-to-value ratios at the time of the reciprocal sale, and
> 10. have all security properties for both sides of the transaction in the same state.
>
> When the aggregate principal amounts are not the same and the principal amount of the mortgage loans purchased is greater than the principal amount of the mortgage loans sold, the purchaser should record the additional principal. The difference between the additional principal and the additional cost should be recorded as a discount and amortized over a period of not less than ten years. If the principal amount of the mortgage loans purchased is less than the principal amount of those originally sold, the difference should reduce its loan account. The difference between the reduction in loans and the amount of cash received should be charged to a loss on sale of mortgage loans.
>
> If a reciprocal sale does not meet all of the above criteria, the institution must record losses resulting from the sale.

On April 13, 1981 Centennial entered into four participation agreements with FNMA, a congressionally chartered corporation which is the principal buyer and seller of mortgages in the secondary mortgage market. Pursuant to these agreements, Centennial acquired a 90%

participation in 78 conventional home mortgages from FNMA and a 90% participation in 299 FHA/VA home mortgages from FNMA. FNMA acquired from Centennial a 90% participation in 85 conventional home mortgages and a 90% participation in 335 FHA/VA home mortgages. These reciprocal loan transactions met all of the requirements of R-49. Also, the loans adhered to several additional guidelines set by FNMA, which resulted in even greater similarity between the loans exchanged. Included in the FNMA guidelines was the requirement that all loans not have been delinquent for more than thirty days during the previous year. The transactions were made for the following cash payments:

Loan Class	Centennial's Receipts	FNMA Receipts	Difference to Centennial
Conventional	$1,827,784.47	$1,827,788.15	$[3.68]
FHA/VA	3,834,258.57	3,834,256.42	2.15
	$5,662,043.04	$5,662,044.57	$[1.53]

The face amounts of the mortgage participation agreements by Centennial and FNMA were as follows:

Loan Class	Loans Centennial Transferred	Loans FNMA Transferred	Difference to Centennial
Conventional	$2,655,891.41	$2,655,896.76	$[5.35]
FHA/VA	5,825,370.06	5,825,366.80	3.26
	$8,481,261.47	$8,481,263.56	$[2.09]

thus, because the mortgages included in the reciprocal sale bore an interest rate that was lower than the then prevailing interest rate for such mortgages,[1] Centennial suffered

[1] The mortgages in these transactions bore interest rates ranging from 6.75-9.875%, rates significantly lower than the market rate prevailing on April 13, 1981.

a loss of $2,819,218.43 in 1981, which it (properly per R-49) did not record for financial and regulatory purposes. This figure represents the difference between Centennial's acquisition cost, i.e., basis, of its old mortgages and the amount Centennial received from FNMA for these mortgages. However, Centennial claimed a tax loss for this amount in 1981.[2] Since Centennial was already in a loss position for that year, the tax loss was used to create a net operating loss and carried back to eliminate all of Centennial's tax liabilities beginning in 1969 through 1980 (1971 excluded). This claimed tax loss is the main source of controversy in this suit.

In determinimg the tax consequences of the reciprocal loan transactions, the method by which the mortgage loans were selected and matched beforehand deserves mention. Centennial had STM, its loan servicer, prepare two computer tapes—one for conventional and the other for FHA/VA mortgages—and provided them to FNMA to be matched with FNMA's loans, in strict compliance with R-49 and FNMA criteria.[3] Centennial did not review the loans before sending them to FNMA. As a result of the matching process, the mortgages were paired precisely by mortgage type (conventional or FHA/VA) and interest rate. They also had nearly the same remaining years to maturity, loan to value ratios, and aggregate principal balances.[4]

[2] Like Centennial, FNMA did not claim a loss for financial or regulatory accounting purposes, but did claim a tax loss. FNMA has participated in numerous R-49 transactions and has claimed millions of dollars in reduced taxes—the subject of other litigation across the country.

[3] Evidence at trial indicated that FNMA disqualified some of the mortgages Centennial transferred, because they failed to meet the requirements of R-49. Testimony of Senning.

[4] Testimony at trial (Spatt) revealed that the aggregate principal balances of the loans were matched more closely than R-49 required.

Centennial received a computer printout from FNMA approximately one week before the reciprocal loan transactions were entered into, designating the two groups of mortgages which had been paired. Centennial did not object to any of the mortgages transferred to it by FNMA. Although Centennial had underwritten each of the mortgage loans it transferred, it conducted no new credit checks, appraisals, or underwriting of the loans it was receiving, nor did it review any of the mortgage file documents related to these loans.[5] Testimony of Henley. Centennial was, however, given the addresses of the residential property which provided the collateral for the mortgages it received and it conducted visual inspections of several of the Dallas area properties prior to signing the four loan agreements. Centennial was able to ascertain that the mortgages sold by Centennial were concentrated in north Texas, while the loans Centennial acquired were located throughout more counties in Texas and were located in a greater number of cities.

The pricing or valuation of all paired mortgages in the four participation sales agreements was established by reference to FNMA's new money auction rate for April 1981. To arrive at a price, one common discount factor was applied to each side of the transaction on all conventional loans. The same was done for all FHA/VA loans using a slightly different discount factor.[6] Charles

[5] In fact, Centennial did not receive until 1987 any files on the loans it acquired in 1981. These file documents ordinarily reveal such information as the identity of mortgagors, notes, deeds of trust, loan applications, appraisals, credit reports, employment confirmations, and loan to value ratios. Evidence at trial suggested that this information was not available from FNMA in 1981. Testimony of Senning.

[6] On all conventional loans, a FNMA auction rate of 15.419% was converted to a price of 68.82 by using a discount factor of 31.18. On all FHA/VA loans, a FNMA auction rate of 15.743% was converted to a price of 65.82 by using a discount factor of 34.18.

Senning, Centennial's Chief Executive Officer, testified that these discount rates were dictated by FNMA and were not negotiable. The value of each individual loan was therefore not established by Centennial. The two participation sales agreements on each side of the transaction were consummated by conveyance of 90% interests in the group of conventional loans and the group of FHA/VA loans together with a simultaneous wire transfer of money by both Centennial and FNMA to the other's account. As Centennial did not have the $5,662,044.57 to cover the payment it made to FNMA, it borrowed funds from the Bank Board. In doing so, Centennial incurred one day's interest on the loan, which it immediately repaid with the $5,662,043.04 received from FNMA for the loans transferred. After completion of the transactions, STM continued to service the mortgage participation interests conveyed to FNMA, as it had prior to the agreements. Centennial continued to receive monthly remittance reports from STM and retained 10% of the remittance, while forwarding the remaining 90% to FNMA. Likewise, Centennial's new participation interests continued to be serviced by FNMA's seventy-six loan servicers for these particular mortgages. Centennial also received 90% remittances from this arrangement. Thus, while mortgage ownership interests were conveyed in the transactions, the actual mortgages never changed hands, and borrowers were not aware that the transaction had taken place. Testimony of Senning.

On February 4, 1982, Centennial filed for a tentative allowance of refunds for the taxable years 1969 through 1980 (1971 excluded) resulting from the carry-back of the claimed $2,819,218.43 loss sustained as a result of the reciprocal loan agreements. Disallowance of this claimed loss by the government led to the assessments made against Centennial, and ultimately to this litigation.

B. ***Contentions of the Parties***

Centennial contends that this case focuses on the "simple question" of whether it sold and/or exchanged its 90% interests in conventional and FHA/VA loans, either of which would result in a realization event for tax purposes, allowing Centennial to claim its alleged loss of $2,819,218.43 in 1981.

Centennial first argues that the conveyance of mortgage loans to FNMA for cash constituted a sale and therefore, *ipso facto*, a realization event, and that the sale was bona fide because Centennial actually and permanently disposed of 90% interests for a fair market value. Alternatively, Centennial argues, if the transaction is characterized as an exchange, a realization event also occurred, because the mortgage loans Centennial received from FNMA did not confer the same interest in the same property as the mortgage loans Centennial transferred to FNMA in the exchange. Centennial maintains that there are numerous differences between the mortgages it conveyed and those it received, and that the mortgage loans should be looked at individually rather than as four "pools" of conventional and FHA/VA loans.

To begin with, Centennial says that it disposed of loans in which it originally held a 100% interest while receiving from FNMA in return 90% participatory interests in loans. The mortgages Centennial transferred were serviced by one servicer, whereas those it acquired were serviced by over seventy servicers. The obligors on and the property securing each mortgage in the transaction were also different from one another. Centennial maintains that borrowers can vary in innumerable ways, including age, education, occupation, life expectancy, credit attitudes, etc. Furthermore, the participations conveyed by Centennial were secured by property concentrated in north Texas,

and were predominantly in urban areas, while those it received were secured by properties dispersed throughout Texas and situated in more rural locations. The mortgages Centennial transferred were also concentrated in more "mobile" areas than the mortgages it received; that is, areas where homeowners move on a frequent basis. Testimony at trial by Christine Henley and Charles Senning, officers of Centennial, and by John Danforth, an expert witness for Centennial, suggested that, based on their past experiences, the more mobile and urban an area is, the greater likelihood that mortgates will be prepaid or defaulted on.[7] This information, they claim, was known by Centennial at the time of the R-49 transaction. Mr. Danforth also testified that the inherent differences in borrowers and in location of collateral placed Centennial in an economic position after the reciprocal sale transaction significantly different from its economic position before the transaction. Centennial argues that the ten criteria required to match the mortgage loans in an R-49 transaction do not account for the numerous differences that Centennial alleges existed between the purchased and sold mortgages. Therefore, Centennial contends, the "substantially identical" standard of R-49 is irrelevant in determining what constitutes a realization event for tax purposes.

The government responds that Centennial is not entitled to realize a $2,819,218.43 tax loss because Centennial's reciprocal sale of mortgages is, in fact, a "disguised exchange" or "swap", which left Centennial in the same economic position both before and after the mortgage transaction. The government argues that the transaction was a single inseparable deal. It points to the simultaneous

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[7] Information collected in 1987 regarding post-transaction performance of the loans, which was presented at trial, showed that these predictions in fact proved true. Centennial Exhibits 28 and 29.

transfer of identical interests in identical types of loans which, after an exchange of over $5 million, resulted in only a $1.53 in additional cash. It claims that the transaction was structured as an exchange to comply with R-49's reciprocal requirements, so that neither Centennial nor FNMA had to record a loss from the transaction on either financial or regulatory reports.

The government contends that this "exchange" involved mortgages which were, according to R-49's criteria, "substantially identical," and for tax purposes, "not materially different in kind or extent." It claims that four "pools" of mortgages resulted from the transaction (one conventional pool and one FHA/VA pool on each side of the deal) and points to testimony from Mr. Danforth, an expert witness for Centennial, that secondary mortgage market transactions normally involve pools or packages of loans. In fact, in this instance pricing was accomplished on a pool-wide basis and therefore did not take individual differences of the loans into account.[8] The government produced expert testimony from Chester Spatt to show that the differences among the loans which had been enumerated by Centennial were immaterial and irrelevant in the context of the secondary mortgage market. In order for there to be a basis for distinguishing among financial assets, such as the mortgage loans in this transaction, information on specific variables common to the four pools would have to be known at the time of the transaction in order to influence cash flow expectations in the market place.[9] Mr. Spatt's testimony further suggested that based

[8] The government elicited testimony from Mr. Senning, Centennial's Chief Executive Officer, that default and prepayment predictions regarding the loans at the time of the transaction could only have been done on a pool-wide rather than on an individual basis.

[9] This theory is commonly referred to as the Capital Asset Pricing Model.

on the lack of information available in April, 1981 to Centennial and the market in general regarding differences in individual borrowers or collateral in the mortgage exchange, the market would not have been in a position to perform materially distinct prepayment to default expectations for the reciprocal sale of the loans. R-49 criteria, on the other hand, related to fundamental characteristics in the economy which were known to the market at the time of the transaction. The characteristics were not materially distinguishable in kind or extent in the eyes of the market because of the similarity of the cash flow expectations among the four sets of mortgage pools.

Alternatively, the government contends that since Centennial did not report a loss for financial and regulatory purposes, it cannot realize a loss for tax purposes. It argues that since Centennial's accrual method of accounting, which follows generally accepted accounting principles ("GAAP") and regulatory accounting principles ("RAP") clearly reflected that Centennial realized no loss on the exchange of mortgages in 1981, then under I.R.C. § 446,[10] Centennial's taxable income should have been

[10] Section 446, entitled "General rule for methods of accounting," provides, in part:

> (a) *General rule.* – Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.
>
> (b) *Exceptions.* – If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.
>
> (c) *Permissible methods.* – Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting –
>
> (1) the cash receipts and disbursements method;

computed on the same basis. Centennial responds that financial and regulatory accounting methods do not govern the realization of tax gains or losses, and that a taxpayer's "method of accounting" in keeping its "books" is not controlled by GAAP or RAP financial statements.

Even if a loss is "realized" under the Code, the Government contends that the loss should not be "recognized" for tax purposes because I.R.C. § 1091 applies to the present case. Section 1091 provides that a loss realized on the sale of stock or securities should not be deducted if, within a 30 day period before or 30 day period after the sale, the taxpayer reacquires "substantially identical" stock or securities. The government argues that the mortgages involved in the exchange between Centennial and FNMA should qualify as "stock or securities" since mortgages are debt instruments secured by collateral. Furthermore, the government urges, since the pools were substantially identical, the mortgages fall within the ambit of Section 1091. Centennial responds that Section 1091 is nonapplicable to the present case, because the mortgages involved in the reciprocal sales agreements do not constitute "stock or securities" within the meaning of Section 1091. Instead, Centennial claims, Section 1091 refers only to bonds, debentures or other obligations which are fungible with other debt instruments in the same class. Additionally, it submits that bilateral contracts are not securities.

Finally, the government contends that should the Court find that the loss claimed by Centennial is to be realized and recognized, the loss still does not qualify as a tax

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(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

I.R.C. § 446(a), (b), and (c).

deduction. In order to be deductible, the government argues that the loss must be bona fide and have a business purpose aside from any tax considerations. It asserts that Centennial's reciprocal agreement was devised exclusively to reduce Centennial's tax liabilities and that it lacked economic substance and validity. The government adduced deposition testimony from Robert Mahn, Senior Vice-President of FNMA, that the only additional capital derived from the R-49 transaction was money received as the result of a tax benefit. Even though savings and loan institutions were in dire need of additional capital, the transaction itself did not generate any new funds. Furthermore, Christine Henley, Centennial's Vice-President, admitted during trial that although Centennial could predict at the time of the R-49 transaction that the loans it was transferring to FNMA would prepay faster, thus generating needed capital, Centennial nonetheless decided to transfer the loans. The government further contends that the agreements did not constitute a bona fide transaction entered into with a legitimate non tax-motivated business purpose as its primary objective. It points to the fact that FNMA auction rates were automatically applied to the loans to determine their price without any arms length negotiations. It also points to the reports prepared by Centennial's accountants before the agreements were signed which reflect the carefully calculated amount of expected refund, including interest. Centennial Exhibit 1. In addition, the government submits that the association's Board minutes during this time reflect only the desire for a tax refund. Government Exhibit 6.

Centennial responds that the government's arguments are merely "glosses" on the realization doctrine. Centennial contends that a business purpose is not a necessary prerequisite for a tax deduction; in any event, Centennial says it had several business purposes for the transaction.

These included diversifying its collateral, decreasing the risks inherent in a geographically concentrated loan portfolio, decreasing its delinquency rate, and improving the quality of the mortgage servicing it received. Additionally, Centennial wanted to launch itself into the secondary mortgage market, get acquainted with FNMA, and educate its officers and employees about secondary mortgage market transactions generally.

C. *The Exchange of Mortgages*

Centennial's claim for a refund with respect to its R-49 transaction in the secondary mortgage market presents the Court with a case of first impression. At the outset, the Court must determine whether or not the mortgage transaction constituted an event which caused the realization of a loss to Centennial. Section 1001 of the Internal Revenue Code provides, in part:

> (a) *Computation of gain or loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
>
> (b) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received . . .

The first step in resolving the realization question is to determine whether the mortgage loan agreements are properly characterized as a sale or as an exchange.

As a general rule, the substance of a transaction controls its tax consequences rather than its form or the label given to it by the taxpayer. *Diedrich v. Commissioner of*

Internal Revenue, 457 U.S. 191 (1982); *Commissioner of Internal Revenue v. P.G. Lake, Inc.*, 356 U.S. 260 (1958); *Commissioner of Internal Revenue v. Court Holding Co.*, 324 U.S. 331 (1945). Through most of its argument, Centennial refers to the transaction as a sale. However, merely calling the transaction a sale, does not make it one. Centennial urges that its disposition of conventional and FHA/VA loans for cash should be the sole focus of the Court's analysis.

The court in *Crenshaw v. United States*, 450 F.2d 472 (5th Cir. 1971), *rev'g*, 315 F. Supp. 814 (N.D. Ga. 1970), *cert. denied*, 408 U.S. 912 (1972), addressed this same approach:

> [Taxpayers] cannot compel a court to characterize the transaction solely upon the basis of a concentration on one facet of it when the totality of circumstances determines its tax status. The most obvious answer to Taxpayer's argument that the parties' characterization is conclusive is that such a result would completely thwart the Congressional policy to tax transactional realities rather than verbal labels . . . Otherwise, form, rather than substance, would invariably prevail.

Id. at 477-78. The Court is unable to accept Centennial's position that one aspect of the transaction should be analyzed separate and apart from the substance of Centennial's and FNMA's coordinated actions. Centennial's position ignores the reality of FNMA's concomitant role in the mortgage transaction, which was vital to the success of meeting the requirements of R-49, the centerpiece of the parties' deal.

In this light, the Court examines the entire situation surrounding the "reciprocal sale," and finds that what took place was an exchange of mortgage loans. The Fifth

Circuit in *Yarbro v. Commissioner of Internal Revenue*, 737 F.2d 479 (5th Cir. 1984), *reh'g denied*, 742 F.2d 1453 (5th Cir. 1984), *cert. denied*, 469 U.S. 1189 (1985), held that an "exchange" requires a giving, a receipt, and a connection between two things regarded as equivalents. *Id.* at 483. In *Carlton v. United States*, 385 F.2d 238 (5th Cir. 1967), the court ruled that "[t]he very essence of an exchange is the transfer of property between owners while the mark of a sale is the receipt of cash for the property," *id.* at 242, but scrutinized whether the cash in question was earmarked for the subsequent purchase, noting that the receipt of funds which are "unfettered and unrestrained" signifies a sale of the property. *Id.* at 243. *See also, Swaim v. United States*, 651 F.2d 1066 (5th Cir. 1981). Although *Carlton* and *Swaim* dealt with I.R.C. § 1031, which refers to exchanges of like kind property (excluding among other things, evidences of indebtedness) used in a trade or business or for investment, the definition of an exchange in these cases is useful in the instant case.

The Court finds that the funds received by Centennial and FNMA from one another in the reciprocal sales transaction were inextricably linked. By the very nature of R-49's reciprocity, the cash, which was wired on the same day to both Centennial's and FNMA's respective accounts, cannot be considered to be anything other than precommitted to the closing of the deal.[11] That the transaction was an exchange is also reinforced by the evidence that the pricing of the loans was not negotiated but was dictated by FNMA, and that the exchange of over $5 million in mortgages by each party, resulted in a difference of only $1.53

[11] The Court notes that Centennial had to borrow funds from the Bank Board in order to cover its side of the transaction, incurring only one day's interest because it was able to repay incurring only one day's interest because it was able to repay the loan almost immediately upon receiving the cash from FNMA's "purchase."

cash. Under these circumstances, the *form* of contemporaneously wiring money to bank accounts in order to purchase mortgages camouflages what is, in *substance*, a simple exchange of mortgages.

A finding that the groups of mortgages were exchanged does not end the inquiry. Even an exchange can be a realization event under Section 1001 of the code. To complete the analysis, the Court must also decide whether the loans exchanged differed from one another to an extent or in such a way as to leave Centennial in a different economic position after the transaction. In other words, after the reciprocal mortgage transaction, was Centennial actually poorer to the extent of the loss claimed?

The parties disagree on the proper standard to apply in determining to what extent the loans must be different in order for Centennial to be able to realize a loss. The Government urges that the correct approach is to look to Treas. Reg. § 1.1001(a), which states:

> Except as otherwise provided in Subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property *differing materially either in kind or in extent*, is treated as income or a loss sustained. . . (emphasis added).

In the government's view, the computer-matched loans which adhered to specific criteria so as to make them "substantially identical" under R-49, cannot differ materially. According to Centennial, Section 1.1001-1(a) is nothing other than a shorthand reference to the realization cases and has no independent significance outside of their holdings. Centennial submits that a realization of a loss occurs when there is a complete disposition of an interest in an asset whether by means of a sale or an exchange, as long as an "identical" asset is not acquired in

exchange. Centennial bases this broad interpretation of a realization event on *Marr v. United States,* 268 U.S. 536 (1925); *Weiss v. Stearn,* 265 U.S. 242 (1924); and *Eisner v. Macomber,* 252 U.S. 189 (1920). In Centennial's view, the mortgage loans exchanged were not identical; and if the Court decides that Section 1.1001-1(a) applies to the transaction, the loans were also not materially different in kind or extent.

The Court agrees with Centennial that *Macomber, Weiss,* and *Marr* are important cases to consider in determining when a realization event has taken place for tax purposes, but finds that Centennial's analysis of them ignores the fundamental reasoning of the cases. In *Eisner v. Macomber, supra,* the taxpayer received a pro rata stock dividend (as opposed to a capital dividend) which increased the number of shares of stock she held in the corporation, but did not change the percentage of her stock in the corporation in relation to other shareholders. The Court found that stock certificates were only legal rights with respect to the corporation's entire assets, and the stockholder was receiving nothing out of these assets for her separate use and benefit. Accordingly, no income was realized as a result of the transaction. While Centennial emphasizes that the rights of the stockholder in *Macomber* remained the same despite issuance of the stock dividends, the Court in that case also made it clear that "the corporation is no poorer and the stockholder no richer than they were before." *Id.* at 203. Thus, there was no change in the taxpayer's economic wealth after the transaction was completed.

In *Weiss v. Stearn, supra,* the Court examined a scheme whereby an existing corporation had been liquidated, assets of the corporation were transferred to a newly formed corporation within the same state, and money was circuitously transferred by the new investors back to the

old shareholders. This resulted in the new investors holding 50% of the stock in the new corporation and the old shareholders receiving the cash therefrom. In applying a substance over form analysis to the multi-step transaction, the Supreme Court held that a gain was realized with respect to the one-half of the stock sold for cash; however, with respect to the other half of the stock retained by the old shareholders, the Court stated:

> We can not conclude that mere change for purposes of reorganization in the technical ownership of an enterprise, under circumstances like those here disclosed, followed by issuance of new certificates, constitutes gain separated from the original capital interest. *Something more is necessary—something which gives the stockholder a thing really different from what he theretofore had.*

Weiss, 265 U.S. at 254 (emphasis added). This language does not support Centennial's broad conclusion that *Weiss* stands for the proposition that a realization event occurs in all instances other than when a taxpayer is left with "identical interests in identical assets" following a transaction. Although the stock interests in *Weiss* remained essentially the same after the "reorganization" of the corporation, it does not automatically follow that that situation determines the standard to be applied in denying the realization of a gain or loss in all cases and contexts. While the *Weiss* Court suggests that, for a realization event to occur, "something more is necessary"—the facts of that case, because the stock interests had stayed the same, do not provide an answer to what "a thing really different" might be.

Similar in some respects to *Weiss, Marr v. United States, supra,* sheds further light on this issue. A new corporation was organized in a different state to take over the

assets and assume the liabilities of an old corporation. The Court in *Marr* held that the new securities which were issued were not stock dividends and that a gain was realized on the value of new stock above the cost of the old securities. It made particular note of the fact that the corporations had been organized in different states with laws reflecting different rights and powers, and that a 6% nonvoting preferred stock in the new company was "essentially different" from a 7% voting preferred and common stock, subject to different amounts of preferred stock priorities and to a different amount of annual dividend on the preferred stock. *Marr,* 268 U.S. at 541-42. Thus, the Court more carefully defined how closely related property involved or exchanged in a transaction must be in order to determine whether a gain or loss is realized, focusing on economic variables in differentiating the two.

D. *The Mortgages Were Not Materially Different*

It is well recognized that the realization of a loss is governed by the same precepts as the realization of a gain. I.R.C. § 1001. The Court concludes that the standard under Treas. Reg § 1.1001-1(a) requiring that the property exchanged in a transaction be materially different in kind or extent before a loss will be realized, is applicable to the mortgage loan agreements in the present case. The validity of this standard finds clear support in *Weiss* and *Marr.* Moreover, Treasury Regulations, in general, are given great deference in interpreting the Internal Revenue Code, and have the effect of law as long as they are correctly promulgated and reasonable and are not plainly inconsistent with the statute that authorizes them. *United States v. Correll,* 389 U.S. 299, 305-307 (1967); *Commissioner of Internal Revenue v. South Texas Lumber Co.,* 333 U.S. 496, 501 (1947). The Court finds that Treas. Reg. § 1.1001-1(a) meets these criteria and that it reflects the reality that

property exchanged does not have to be absolutely identical to leave a taxpayer in a similar economic position before and after an exchange.

After reviewing all of the testimony, evidence, and theories presented in this case, the Court is of the opinion that the conventional and FHA/VA loans which Centennial exchanged with FNMA were not materially different from those it received. *See* Rev. Rul. 85-125, 1985-2 C.B. 180 (where Internal Revenue Service reached same conclusion with respect to a R-49 transaction); *cf.,* Rev. Rul. 81-204, 1981-2 C.B. 157. In making this determination, the Court gives effect to the economic realities in existence *at the time of the transaction.*

Those economic characteristics of the mortgages which meet the R-49 criteria were clearly known to the market place in April, 1981. R-49 severely restricted potential differences between the loans, and additional criteria added by FNMA restricted them to an even greater extent. All the loans involved single-family residential mortgages and were matched by the same loan type, interest rates and stated terms to maturity. They also were paired according to substantially similar remaining terms to maturity and aggregate principal balances, with no loan delinquent for more than thirty days during the last year. The R-49 criteria assured that the mortgages after the matching process would not be materially different.

Moreover, while the "substantially identical" language within R-49 is not a standard promulgated under the Internal Revenue Code, it is relevant in determining whether material differences existed between the loans in this transaction. It was obviously the intent of R-49 that once the strictures imposed by its ten criteria were met, the mortgages would be so closely paired as to be "substantially identical." The Court therefore has given weight to the R-49 "substantially identical" standard in reaching its deci-

sion that the loans were not materially different in kind or extent.

Furthermore, in light of the Danforth testimony that the secondary mortgage market routinely deals with packages of mortgages and after reviewing the manner in which the mortgages in this transaction were matched and priced, the Court finds that "pools" of mortgages (two conventional and two FHA/VA) were swapped with little if any reference to possible differences in the individual characteristics of the loans involved. Centennial conducted no new appraisals or credit checks of the computer-matched loans it was to receive in the transaction. The Court finds it difficult to attach significance to loan characteristics of which Centennial itself had no knowledge at the time of the transaction.

Centennial argues that although precise information regarding the loans may not have been known at the time of the "reciprocal sale," it could be predicted based on inherent differences which existed among individual borrowers and location of collateral that the loans would perform differently and thus place Centennial in a different economic position as a result. However, the Court, mindful of the evidence presented by Centennial providing possible correlations between individual differences among the loans and prepayment and default tendencies, finds that these predictions provide an uncertain basis upon which to determine a change in Centennial's economic position. The Court is persuaded by the testimony of Mr. Spatt, the government's expert, which suggested that because information was not available at the time of the transaction regarding individual differences among the loans, the market place was unable to and did not differentiate between the pools. Lacking economic relevance, these differences were not materially distinguishable and were therefore irrelevant, especially to

a secondary mortgage market dealing in pools of similarly seasoned mortgages.

E. *There Was No Loss Realized*

In order to be deductible, "losses must be 'realized' by some closed 'identifiable event' . . . and [the Internal Revenue Code] requires such losses to be actual and real." (cites omitted) *Shoenberg v. Commissioner of Internal Revenue,* 77 F.2d 446, 448 (8th Cir. 1935) *cert. denied,* 296 U.S. 586 (1935). The realization of a loss must be evidenced by an event which makes the taxpayer "poorer to the extent of the loss claimed." *Id.* at 419; *see also Macomber,* 252 U.S. at 203.

While R-49 provided the basis for a valid transaction, it also prevented the realization of a tax loss. Centennial was no poorer after the transaction than before. It reflected no loss on its books for regulatory and accounting purposes and thereby avoided problems with its depositors, investors, and regulators. It appears to the Court that by means of the mortgage swap, Centennial hoped to create a loss without any real change in its economic status.

Taxation, however, is concerned with realities rather than appearances, *Crenshaw v. United States,* 450 F.2d 472, 475 (5th Cir. 1971), and no loss can be claimed that is not real. The loss which Centennial claims it suffered as a result of the transaction is the paper loss it had been suffering all along because its old fixed-rate mortgages had declined in value. A decline in valuation without realization, however, is not enough to entitle an institution to deduct a loss. *Anderson Clayton & Co. v. United States,* 562 F.2d 972, 988 (5th Cir. 1977), *reh'g denied,* 565 F.2d 1215 (5th Cir. 1977), *cert. denied,* 436 U.S. 944 (1978).

A taxpayer has a right to arrange his affairs as he wishes, with tax considerations in mind; however, this

must be done within the framework of applicable tax law. *Gregory v. Helvering,* 293 U.S. 465, 469 (1935). While Centennial possibly had business purposes for entering into the transaction with FNMA, an issue which the Court does not reach, the Court considers that the most certain immediate economic benefit to Centennial was the opportunity to take a substantial tax loss without claiming a loss on its books. In fact, the Court can find no other rationale for R-49. Although Centennial was admittedly in great need of cash, given the economic climate and its financial position in 1981, the "reciprocal sale" generated no new funds (except for $1.53), since Centenial and FNMA each received two pools of old, fixed-rate, low-interest mortgages in return for the mortgages it transferred. If Centennial claims the benefits of alleged business purposes for entering into the R-49 transaction, it must also bear the burdens. It cannot have its cake and eat it too.

There is no realized loss. The Court therefore does not reach the other issues raised regarding the R-49 loan transaction.

II. THE CERTIFICATES OF DEPOSIT

During 1981, Centennial had liabilities on its books in the form of certificates of deposit. Each certificate of deposit agreement required the depositor to keep the funds on deposit with Centennial for a fixed term, which varied according to the length of time a depositor chose to invest his funds. Should the principal amount of a certificate be withdrawn before maturity, the depositor was subject to a "premature withdrawal penalty"; that is, the depositor received back an amount of money which consisted of the principal on deposit plus interest to date of withdrawal, less the penalty for the premature withdrawal. The penalty was always exacted by Centennial at the time the certificate of deposit was withdrawn. The penalty, also called a forfeiture, was predetermined and the amount was prescribed by federal law. *See* 12 C.F.R. § 1204.103 (1981).[12] In 1981, Centennial received $258,019 as a result of premature withdrawals on certificates of deposit.

It is undisputed that gross income under I.R.C. § 61(a) means "all income from whatever source derived." Gross income includes "income from the discharge of indebtedness" under Section 61(a)(12). Section 108(a)(1)(c) provides as follows:

> Gross income does not include any amount which (but for this subsection) would be includable in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if the indebtedness discharged is qualified business indebtedness.

Section 108(d)(4)(a) defines qualified business indebtedness as indebtedness "incurred or assumed by a corporation," and Section 108(c) allows a corporation to reduce the adjusted basis of its depreciable assets under Section 1017[13]

---

[12] 12 C.F.R. § 1204.103 is promulgated by the Depository Institutions Deregulation Committee (DIDC), which was established by the Depository Institutions Deregulation Act of 1980, 12 U.S.C. § 3502 (1980).

[13] Section 1017 provides, in part:

> (a) *General rule.* – If –
>
> (1) an amount is excluded from gross income under subsection (a) of section 108 (relation to discharge of indebtedness), and
>
> (2) under subsection . . . (c)(1)(A) of section 108, any portion of such amount is to be applied to reduce basis,
>
> then such portion shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs.

I.R.C. § 1017(a).

by the amount of indebtedness."[14]

Centennial contends that it properly characterized the income it received from the premature withdrawal penalties as "income by reason of the discharge of indebtedness" under Section 108 and thus, in conjunction with Section 1017, should be allowed to reduce its adjusted basis in depreciable assets over a number of years rather than including the forfeiture amounts in its gross income in 1981. The government is in agreement that these amounts realized by Centennial represent income. However, it disagrees that the penalties represent income realized by the discharge of indebtedness. It contends that the rationale of the Tax Court in *Colonial Savings Association v. Commissioner,* 85 T.C. 855 (1985) is dispositive of the certificates of deposit issue. Centennial does not dispute that *Colonial Savings* is directly on point; instead, it submits that the case is wrongly decided and should not be followed by this Court. Since it appears that the facts are not in dispute, the only issue to be resolved by this Court is a legal one: Are the premature withdrawal penalties associated with the certificates income from the discharge of indebtedness within the meaning of Sections 61(a)(12) and 108?

In *Colonial Savings,* the Tax Court concluded that premature withdrawal penalties realized by a savings and loan institution on certificates of deposit did not constitute income realized by reason of the discharge of indebtedness. The Tax Court held that the penalty agreed to in advance, is "a separate and distinct obligation required of depositors for early withdrawal and not a forgiveness or

[14] The Court notes that the parties did not discuss in their briefs, and the Court therefore does not address, the fact that the applicable law in this case under §§ 108 and 1017 was repealed in the 1986 revision of the Internal Revenue Code.

discharge of debt. The debt to the depositor was not canceled or discharged, it was simply reduced." *Id.* at 861. The Tax Court explained that Section 108 only applies to "pure" cancellation of indebtedness income, not to an instance, like the one before it, where forfeiture was only a "method" by which a creditor makes a payment to a debtor. *Id.* at 866. (citing *OKC Corp. & Subsidiaries v. Commissioner,* 82 T.C. 638, 649 (1984) and *Spartan Petroleum Co. v. United States,* 437 F.Supp. 733, 737 (D.S.C. 1977)). After reviewing the legislative enactments which preceded Sections 108 and 1017 providing relief for bankrupt and insolvent debtors in the form of a basis reduction, the Tax Court found that a similar need for relief was absent under the circumstances of the case before it. It thus concluded that any hardship that the savings and loan association might have suffered was sufficiently compensated for by the forfeiture payment, prior use of depositors' funds, and a tax deduction for interest credited and not necessarily paid.[15]

Centennial disagrees with the conclusion reached in *Colonial Savings* in several respects. It submits that the certificate of deposit agreement is a contract which creates a debtor-creditor relationship between Centennial and its depositors. Centennial maintains that the premature withdrawal aspect of the agreement is not separate from the certificate of deposit contract. The agreement, it contends, calls for Centennial to repay the borrowed amounts plus interest at maturity; at any earlier time, Centennial is

[15] Regarding this latter deduction, the Tax Court explained: "Because a certificate may not mature prior to the end of petitioner's [taxpayer's] taxable year, petitioner may have enjoyed some deferral without secs. 108 and 1017. The penalty may fall into a subsequent year and not have the tax effect of 'washing out' in the same taxable period." *Colonial Savings,* 85 T.C. at 867, n.24.

to pay a lesser amount. Centennial argues that it was discharged from a portion of its indebtedness by paying less to its depositors than the total amount of its debt. The Court agrees.

A taxpayer may realize income by paying an obligation at less than its face value. *United States v. Kirby Lumber,* 284 U.S. 1 (1931). In *Kirby Lumber,* a corporation retired a portion of its own bonds after purchasing them at a price less than the face value which it had received for them when issued. The Supreme Court found that the excess of the issuing price over the purchase price constituted an accession to income, which has been characterized as the income from the discharge of indebtedness. The Court in the present case finds the *Kirby Lumber* rationale to be applicable to the premature penalty issue. When a depositor opens a certificate of deposit account with Centennial, Centennial becomes indebted to its customer for both the principal deposited and the future interest earned. A part of this agreement is that Centennial, the debtor, is excused or discharged from paying its full obligation to the depositor, a creditor, should the depositor withdraw funds prematurely. In 1981, Centennial paid its total obligation under certain certificate of deposit agreements at a lesser amount than the agreement called for, because it was allowed to keep a forfeiture amount resulting from depositors' early withdrawals. Thus, like the corporation in *Kirby Lumber,* Centennial "realized within a year an accession to income." *Id.* at 3.

The government argues that the predetermined, fixed nature of the withdrawal penalty distinguishes the present case from *Kirby Lumber*. The government focuses on the fact that the penalty did not correspond to a discount linked to prevailing market interest rates and was instead a form of liquidated damages.

The Court finds this reasoning misplaced. The early withdrawal penalty provision in the certificate of deposit agreement does not constitute a separate contract, and the fact that the penalty was predetermined does not transform it into one. The Court finds that no *separate* payment was made, whether it was fixed or based on market rates. Moreover, contrary to the Tax Court's holding in *Colonial Savings*, the "purity" of the cancellation of indebtedness represented by the forfeiture income in this case is not at issue, because the penalty provision is an integral part of the contract, not merely an ancillary "method" or "medium" by which the debt was reduced. Thus, the penalty income was liquidated debt, not liquidated damages.

The Court concludes that the $258,019 received by Centennial in 1981 as a result of premature withdrawal penalties constitutes income "by reason of" a discharge of indebtedness within the meaning of both Sections 61(a)(12) and 108. Because there was but one contract, income received by Centennial from premature withdrawals was a direct result of depositors discharging Centennial from its indebtedness to them. The Court further finds that under Section 108(d)(4), the indebtedness was "qualified business indebtedness," thus permitting Centennial to have the tax basis of its property reduced pursuant to Section 1017. Finally, the Tax Court's discussion in *Colonial Savings* regarding the legislative background to Sections 108 and 1017 mentioned, but failed to take into account, that in 1942 Congress removed the unsound financial condition requirement,[16] thus allowing *all* corporations to avail themselves of the benefits which exist under Section 108. The Tax Court's argument that Section 108 is not applicable to a case such as the one before this Court

[16] Revenue Act of 1942, P.L. 77-753.

because it found that the savings and loan association had no need for relief, is therefore antiquated. The Court further considers that the forfeiture amount does not really constitute "relief"; income which falls under Section 108 is tax deferred and ultimately recouped and does not escape taxation. Centennial thus properly characterized its income from early withdrawal penalties as income from the discharge of indebtedness and is entitled to avail itself of Section 108.

III. CONCLUSION

The Court holds that because the mortgage loans in the R-49 transaction were not materially different in kind or extent, thus leaving Centennial in the same economic position before and after the exchange, Centennial is not entitled to claim a tax loss from the R-49 transaction.

The Court also holds that in 1981 Centennial was entitled to treat its income from the premature withdrawal penalty on its certificates of deposit as income from the discharge of indebtedness.

The government will promptly submit a judgment prepared in accordance with this Opinion.

SO ORDERED.

DATED: January 22, 1988.

/s/ Barefoot Sanders

BAREFOOT SANDERS
Acting Chief Judge
Northern District of Texas

APPENDIX C

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 88-1297

CENTENNIAL SAVINGS BANK FSB, PLAINTIFF-APPELLANT, CROSS-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLEE, CROSS-APPELLANT

APPEALS FROM THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF TEXAS

[Filed Jan. 19, 1990]

ON PETITION FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC

(Opinion 11/02/89, 5 Cir., 198__, ____ F.2d ____)

Before: BROWN, WILLIAMS and JOLLY, Circuit Judges.

PER CURIAM:

(X) The Petition for Rehearing is DENIED and no member of this panel nor Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc, (Federal Rules of Appellate Procedure and Local Rule 35) the Suggestion for Rehearing En Banc is DENIED.

( ) The Petition for Rehearing is DENIED and the Court having been pooled at the request of one of the members of the Court and a majority of the Circuit Judges who are in regular active service not having voted in favor of it, (Federal Rules of Appellate Procedure and Local Rule 35) the Suggestion for Rehearing En Banc is also DENIED.

( ) A member of the Court in active service having requested a poll on the reconsideration of this cause en banc, and a majority of the judges in active service not having voted in favor of it, rehearing en banc is DENIED.

ENTERED FOR THE COURT:

/s/ J. S. WILLIAMS
United States Circuit Judge

APPENDIX D

The Internal Revenue Code of 1954 (26 U.S.C. (1982)), as in effect for the tax year at issue, provided in pertinent part:

§ 108. Income From Discharge of Indebtedness

(a) Exclusion from gross income.

(1) In general

Gross income does not include any amount which (but for this subsection) would be includable in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—

(A) the discharge occurs in a title 11 case,

(B) the discharge occurs when the taxpayer is insolvent, or

(C) the indebtedness discharged is qualified business indebtedness.

* * * * *

(c) Tax treatment of discharge of qualified business indebtedness

In the case of a discharge of qualified business indebtedness—

(1) Basis reduction

(A) In general

The amount excluded from gross income under subparagraph (C) of subsection (a)(1) shall be applied to reduce the basis of the depreciable property of the taxpayer.

* * * * *

(d) Meaning of terms; special rules relating to subsections (a), (b), and (c).

(1) Indebtedness of taxpayer

For purposes of this section, the term "indebtedness of the taxpayer" means any indebtedness—

(A) for which the taxpayer is liable, or

(B) subject to which the taxpayer holds property.

* * * * *

(4) Qualified business indebtedness

Indebtedness of the taxpayer shall be treated as qualified business indebtedness if (and only if)—

(A) the indebtedness was incurred or assumed—

(i) by a corporation, or

(ii) by an individual in connection with property used in his trade or business, and

(B) such taxpayer makes an election under this paragraph with respect to such indebtedness.

* * * * *

§ 165. Losses

(a) General rule

There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

§ 1001. Determination of Amount of and Recognition of Gain or Loss.

(a). Computation of Gain or Loss

The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom

over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) Amount Realized

The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) Recognition of Gain or Loss

Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

* * * * *

The Treasury Regulations on Income Tax (26 C.F.R.) provide in pertinent part:

§ 1.1001-1 Computation of gain or loss

(a) General rule

Except as otherwise provided in Subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the

sum of any money received plus the fair market value of any property (other than money) received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 1001(a) through (d) which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and the regulations thereunder (*i.e.*, the cost or other allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized. The basis may be different depending upon whether gain or loss is being computed. For example, see section 1015(a) and the regulations thereunder. Section 1001(e) and paragraph (f) of this section prescribe the method of computing gain or loss upon the sale or other disposition of a term interest in property the adjusted basis (or a portion) of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to the basis of property acquired by gift or by transfer in trust).

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OPPOSITION

BRIEF

No. 89-1926

FILED
AUG 31 1990
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

UNITED STATES OF AMERICA,
Petitioner,

v.

CENTENNIAL SAVINGS BANK, FSB
(RESOLUTION TRUST CORPORATION, RECEIVER),
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

---

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Counter-Question Presented

Whether Section 165 of the Internal Revenue Code precludes the deductibility of losses realized under Section 1001 of the Code upon an exchange of mortgage loans between unrelated financial institutions.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

No. 89-1926

UNITED STATES OF AMERICA,
Petitioner,

v.

CENTENNIAL SAVINGS BANK, FSB
(RESOLUTION TRUST CORPORATION, RECEIVER),
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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RESPONDENT'S BRIEF IN OPPOSITION

JURISDICTION

The judgment of the court of appeals was entered on November 2, 1989. A petition for rehearing was denied on January 19, 1990. (Pet. App. 61a-62a). On April 10, 1990, Justice White extended the time within which to file a petition for a writ of certiorari to and including May 18, 1990. On May 4, 1990, Justice White further extended that time to and including June 8, 1990, when the petition was filed. On July 2, 1990, the time for filing this opposition to the petition for a writ of certiorari was extended to and

including August 8, 1990. On July 27, 1990, a second extension was granted to and including August 31, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

In addition to the statutes and regulations contained in Petitioner's appendix (63a-66a), the following provisions are relevant to this case.

Treasury Regulations (26 C.F.R.) § 1.165-1(b) provides:

> *Nature of loss allowable.* To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and § 1.165-11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

The Depository Institutions Deregulation Committee regulation at 12 C.F.R. § 1204.103 (1981) provided:

> Where a time deposit with an original maturity of three months or more to one year, or any portion thereof, is paid before maturity, a depositor shall forfeit an amount at least equal to three months of interest earned, or that could have been earned, on the amount withdrawn at the nominal (simple interest) rate being paid on the deposit, regardless of the length of time the funds with-

> drawn have remained on deposit. Where a time deposit with an original maturity of less than three months, or any portion thereof, is paid before maturity, a depositor shall forfeit an amount at least equal to the amount of interest that could have been earned on the amount withdrawn at the nominal (simple interest) rate being paid on the deposit had the funds remained on deposit until maturity. Where a time deposit with an original maturity of more than one year, or any portion thereof, is paid before maturity, a depositor shall forfeit an amount at least equal to six months of interest earned, or that could have been earned, on the amount withdrawn at the nominal (simple interest) rate being paid on the deposit, regardless of the length of time the funds withdrawn have remained on deposit.

Section 301 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183, 277-280, amended 12 U.S.C. § 1463(b) to provide, in pertinent part:

> (1) In general. The Director [of the Office of Thrift Supervision] shall, by regulation, prescribe uniform accounting and disclosure standards for savings associations, to be used in determining savings associations' compliance with all applicable regulations.
>
> (2) Specific requirements for accounting standards. Subject to section 1464(t) of this title, the uniform accounting standards prescribed under paragraph (1) shall—

(A) incorporate generally accepted accounting principles to the same degree that such principles are used to determine compliance with regulations prescribed by the Federal banking agencies . . .

COUNTER-STATEMENT OF THE CASE

1. *Reciprocal Mortgage Transactions.* Centennial Savings Bank ("Centennial") was a federally insured mutual savings and loan association chartered under the Home Owners' Loan Act of 1933 and subject to review, supervision and regulation by the Federal Home Loan Bank Board (Bank Board) and the Federal Savings and Loan Insurance Corporation ("FSLIC").[1] In 1981, Centennial's mortgage loan portfolio was composed primarily of fixed-rate, long-term mortgage loans which had been issued in the late 1960s. In the late 1970s and early 1980s, market rates of interest rose to a level in excess of the interest rates being received on long-term mortgages. The higher market interest rates caused the fair market values of the older mortgage loans to fall far below their face amounts. As its mortgage loans fell

[1] While this case was pending on appeal in the circuit court below, Centennial was found insolvent by the Bank Board and FSLIC was appointed receiver. Subsequently, pursuant to the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), Pub. L. No. 101-73, 103 Stat. 183, the Resolution Trust Corporation took over as receiver. Accordingly, the Resolution Trust Corporation as receiver for Centennial is the Respondent in this action.

Pursuant to Supreme Court Rule 29.1, Respondent states that Centennial Savings Bank has no parent companies or non-wholly owned subsidiaries.

in value, Centennial was also forced to offer higher interest rates on deposits to attract funds. Consequently, Centennial was paying more interest on deposits than was being earned from its older loans. (Pet. App. 31a-32a).

At the same time, the profits and cash flow of many savings and loan institutions, like Centennial's, were adversely affected by the devaluation of older, lower interest rate mortgage loans and the higher interest rates required to attract funds. As a result of these economic conditions, it became increasingly difficult for savings and loans to maintain capital reserves and minimum liquidity ratios imposed by the Bank Board. Many of the savings and loans desired to dispose of their low-interest rate mortgage loans and obtain income tax deductions for their actual losses. In some cases, such tax deductions would have created net operating losses that could be carried back to profitable years, generating income tax refunds which would improve cash flow. However, in disposing of their devalued low-interest rate mortgage loans, many savings and loans needed to avoid recording losses which would make them fall below the Bank Board's capital reserve and minimum liquidity requirements and subject them to potential regulatory action. *See San Antonio Sav. Ass'n v. Commissioner*, 887 F.2d 577, 579-80 (5th Cir. 1989), *petition for cert. filed*, No. 89-1928.

In 1980, the Bank Board promulgated a regulatory accounting rule for reciprocal sales of mortgage loans ("Memorandum R-49") that was intended to allow savings and loans to realize and deduct tax losses while not requiring the recording of regulatory accounting losses that would imperil compliance with

the Bank Board's capital reserve and minimum liquidity requirements. *See id.* Memorandum R-49 provided that a savings and loan could sell single-family residential mortgage loans, or a participation interest therein, and not record its loss on the sale for regulatory accounting purposes if other mortgage loans or participations were acquired in a reciprocal transaction that satisfied 10 criteria.[2] If the mortgage loans or participations transferred by each party met each of the 10 prescribed criteria, Memorandum R-49 permitted a savings and loan to not record losses for regulatory accounting purposes, except to the extent of net cash balances paid in the reciprocal sale transaction. (Pet. App. 33a). Consistent with the 10 criteria of Memorandum R-49, the individual mortgage loans that were transferred in a reciprocal sale transaction under Memorandum R-49 had different obligors, different geographic concentrations, different expected payment experiences, and different mortgaged properties with different values securing the loans. (Pet. App. 8a).

On April 13, 1981, Centennial and the Federal National Mortgage Association ("FNMA") engaged in a

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[2] Memorandum R-49 required that the transferred loans: "(1) involve single-family residential mortgages; (2) be of similar type (e.g., conventionals for conventionals); (3) have the same stated terms to maturity (e.g., 30 years); (4) have identical stated interest rates; (5) have similar seasoning (i.e., remaining terms to maturity); (6) have aggregate principal amounts within the lesser of 2 1/2% or $100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash; (7) be sold without recourse; (8) have similar fair market values; (9) have similar loan-to-value ratios at the time of the reciprocal sale, and (10) have all security properties for both sides of the transaction in the same state." (Pet. App. 32a-33a).

reciprocal sale of 90 percent participation interests in a package of mortgage loans. Centennial acquired a 90 percent participation interest in 377 conventional and FHA/VA mortgages from FNMA and FNMA acquired a 90 percent participation interest in 420 conventional and FHA/VA mortgages from Centennial. The mortgage loan participations transferred by Centennial to FNMA had an aggregate face amount of $8,481,261.47 and a fair market value of only $5,662,043.04.[3] The $2,819,218.43 difference represented the true economic loss suffered by Centennial by reason of higher market interest rates. (Pet. App. 34a-35a).

As a result of the reciprocal sale of mortgage loans, Centennial claimed a deductible loss of $2,819,218.43 on its 1981 tax return. This loss contributed to a net operating loss for the 1981 tax year that was carried back to tax years 1969 through 1980 (1971 excluded). For each such year, Centennial filed a claim for refund. Disallowance of the refund claims led Centennial to file a refund suit in the United States District Court for the Northern District of Texas.

The district court treated the issue of the deductibility of Centennial's loss upon the reciprocal sale of mortgage loans as a case of first impression and held that the exchange of mortgage loans was not an event upon which Centennial's loss was realized under Section 1001 of the Internal Revenue Code. The United

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[3] The mortgage loan participations transferred by FNMA to Centennial had an aggregate face amount of $8,481,263.56 and a fair market value of $5,662,044.57. The $1.53 difference in the aggregate fair market values of the transferred mortgages represented the net cash balance paid by Centennial to FNMA (Pet. App. 2a).

States Court of Appeals for the Fifth Circuit reversed, holding that Centennial's $2,819,218.43 economic loss was deductible for federal income tax purposes. The court of appeals' holding was based on two conclusions: (1) Centennial's loss was realized under Section 1001 of the Code upon the occurrence of the mortgage exchange transaction, and (2) Section 165 of the Code does not preclude deduction of a real economic loss that is realized in a bona fide, closed transaction.[4]

2. *Early Withdrawal Penalties.* During 1981, Centennial had substantial liabilities to depositors in the form of certificates of deposit ("CDs"). Each CD agreement prescribed a fixed interest rate for a fixed term of deposit. If a depositor withdrew its funds prior to maturity of the CD, the depositor was subject to a forfeiture of accrued interest. The forfeiture, commonly called a premature withdrawal penalty,[5] was always exacted at the time of premature withdrawal, by subtracting the amount of the forfeited interest from the amount of principal and interest due to the depositor. Applicable regulations of the Federal Depository Institutions Deregulation Committee prescribed different amounts of accrued interest to be forfeited for CDs of different maturities. *See* 12 C.F.R. § 1204.103 (1981). (*Supra*, 2-3).

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[4] References herein are to the Internal Revenue Code of 1954, prior to its recodification by the Tax Reform Act of 1986. Sections 1001 and 165 are unchanged in the Internal Revenue Code of 1986.

[5] The Fifth Circuit below attached no significance to the characterization of the depositor's obligation upon premature withdrawal as a forfeiture or a penalty. (Pet. App. 11a-12a n.5).

During 1981, Centennial realized $258,019 in CD premature withdrawal penalties, which it treated as income from discharge of indebtedness on its 1981 tax return. Although discharge of indebtedness at less than face value constitutes gross income, under Section 108 of the Internal Revenue Code then in force, Centennial was permitted to elect to exclude the discharge of indebtedness income from gross income for 1981 and reduce the basis of its depreciable property in a corresponding amount. This election had the effect of causing such income to be taxed over a period of future years rather than being taxed in full immediately.

The Internal Revenue Service determined that the premature withdrawal penalties did not constitute discharge of indebtedness under Section 108 and, consequently, the penalties could not be excluded from gross income. The district court and the court of appeals below held for Centennial that the premature withdrawal penalties were excludable from gross income as discharge of indebtedness income under Section 108.

Reasons for Denying the Writ

I. Review is Not Warranted on the Reciprocal Mortgage Transaction Issue.

A. There Is No Conflict Among The Courts of Appeals That Losses Were Realized Under Section 1001 of the Internal Revenue Code Upon a Reciprocal Mortgage Transaction.

The question whether real economic losses from a mortgage loan portfolio are deductible for federal income tax purposes as a result of a mortgage exchange transaction meeting the requirements of Memoran-

dum R-49 has been addressed by three courts of appeals. The Fifth Circuit in this case and in two companion cases, *San Antonio* and *First Federal Savings & Loan Association v. United States*, 887 F.2d 593 (5th Cir. 1989), *petition for cert. filed*, No. 89-1927, and the District of Columbia Circuit in *Federal National Mortgage Association v. Commissioner*, 896 F.2d 580 (1990), *petition for cert. filed*, No. 89-1987, held that the losses were deductible. The Sixth Circuit, in *Cottage Savings Association v. Commissioner*, 890 F.2d 848 (1989), *petition for cert. filed*, No. 89-1965, reversed a court reviewed opinion of the Tax Court and held that the losses were not deductible.[6]

[6] The Solicitor General has filed petitions for writs of certiorari seeking plenary review by this Court in this case and in *First Federal*. In *San Antonio*, the Solicitor General has filed a petition for a writ of certiorari but has suggested that the case be held pending disposition of the mortgage exchange issue in another case. (Pet. App. at 13 n.10). The taxpayer has petitioned for a writ of certiorari in *Cottage*. Respondent believes that resolution of the mortgage exchange issue, as restated herein, should be the same in any or all of these cases.

The Solicitor General has also filed a petition for a writ of certiorari in *FNMA*, stating that the question presented there is the same as in this case and in *First Federal*. (Pet. 8). The Solicitor General does not seek plenary review in *FNMA*, asking that its petition should be disposed of as appropriate in light of the Court's disposition of this case and *First Federal*. Respondent believes that the facts in *FNMA* are not the same as in this case or First Federal. In *FNMA*, the taxpayer was not subject to the Bank Board's regulations and accounting rules, including Memorandum R-49. The mortgage exchange transactions executed by the taxpayer met other criteria than those prescribed in Memorandum R-49 and were found by the Tax Court to serve independent business purposes not found, for purposes of summary judgment, to be present in this case or in *First Federal*. *See FNMA*, 896 F.2d at 582-83.

While the Sixth Circuit differed from the Fifth and District of Columbia Circuits as to result, there is no conflict among the circuits that the mortgage exchange transactions caused the losses to be realized under Section 1001. Each circuit has so held.[7]

Petitioner recognizes that it is "black letter law" that the Internal Revenue Code takes gains and losses on property, other than inventory, into account only when they are realized in a taxable event that disposes of the property. (Pet. 14). This realization requirement is codified in Section 1001 of the Code and is well-established in this Court's opinions, dating from the landmark case of *Eisner v. Macomber*, 252 U.S. 189 (1920). *See also Marr v. United States*, 268 U.S. 536 (1925); *Weiss v. Stearn*, 265 U.S. 242 (1924); *United States v. Phellis*, 257 U.S. 156 (1921).

[7] *See Cottage*, 890 F.2d at 852 ("We believe the loss in this case was technically realized in the sense that an earlier decline in value of the fixed-rate mortgage loans was fixed by an identifiable event—the 'reciprocal sales' transaction."); *FNMA*, 896 F.2d at 583 ("[i]n order for a loss resulting from an exchange of property to be recognized for tax purposes it must be realized" and the court went on to find that "FNMA is entitled to recognize the losses it incurred."); *San Antonio*, 887 F.2d at 593 ("We uphold the finding of the Tax Court allowing SASA the deduction of $14,956,898 under the Internal Revenue Code as loss realized through the exchange of materially different property."); *Centennial*, (Pet. App. 9a) ("in accordance with our decision of this day in *San Antonio*, we hold Centennial's R-49 transaction resulted in a realized and recognizable loss for tax purposes because the participation interests exchanged were in mortgages which under the Internal Revenue Code differed materially from each other."); and *First Federal*, 887 F.2d at 595 ("Temple did realize the recognizable loss it claimed on the R-49 transaction.").

Consistent with this settled law, each of the circuit courts that reviewed the deductibility of losses upon the occurrence of a Memorandum R-49 mortgage exchange transaction began its statutory analysis by determining whether the exchange transaction[8] constituted an event requiring realization of the loss under Section 1001. Each circuit court carefully set forth two steps in its statutory analysis of the realization of the losses: (1) specifying the standard for realization under Section 1001 and (2) applying the realization standard to the facts.

The Fifth Circuit and the District of Columbia Circuit held that Section 1001 of the Code and Treasury Regulations § 1.1001-1(a) require that, in order for the exchange to constitute a loss realization event, the exchanged mortgage loans must be materially different. Both the Fifth Circuit and the District of Columbia Circuit concluded that the mortgage loans exchanged in a Memorandum R-49 transaction were materially different. No court of appeals has decided otherwise.

The Sixth Circuit, in *Cottage*, held that Section 1001 and Treasury Regulations § 1.1001-1(a) did not require the exchanged mortgage loans to be materially different in order for the exchange to constitute a realization event. Rather, the Sixth Circuit concluded that Section 1001(c) of the Code requires realization of loss upon the occurrence of an identifiable event fixing the amount of loss and that the Memorandum

[8] All of the circuit courts treated the Memorandum R-49 transactions as exchanges rather than sales of the underlying mortgages or mortgage participations. *See FNMA*, 896 F.2d at 583; *Cottage*, 890 F.2d at 850-51; and *San Antonio*, 887 F.2d at 581.)

R-49 exchange was such an event. *Cottage*, 890 F.2d at 851-2.[9]

Thus, the Sixth Circuit applied a realization standard that permitted realization of losses upon the occurrence of identifiable, bona fide exchanges of mortgages loans. The Fifth Circuit and the District of Columbia Circuit applied a stricter realization standard that required the mortgage loans exchanged to be materially different. Although these realization standards differ, the difference is not relevant, since, in applying the respective standard to the facts before it, each court of appeals held that losses were realized under Section 1001 upon completion of a Memorandum R-49 mortgage exchange transaction.

Thus, there is no conflict among the courts of appeals that economic losses from devalued, low-interest rate mortgage loans were realized under Section 1001 of the Code upon the occurrence of a Memorandum R-49 mortgage exchange transaction. Moreover, each of the three circuits found no statu-

[9] On the issue of realization under Section 1001, the Sixth Circuit adopted the reasoning of Tax Court Judge Cohen's concurring opinion in *Cottage Savings Association v. Commissioner*, 90 T.C. 372, 403 (1988), *rev'd* 890 F.2d 848 (6th Cir. 1989). *See id.*, 890 F.2d at 851-52. The Sixth Circuit and Judge Cohen interpreted Treasury Regulations § 1.1001-1(a) as a computation provision rather than as a provision relating to whether gain or loss is realized. The Sixth Circuit and Judge Cohen reasoned that Section 1001(c) requires realization upon an identifiable event fixing a loss, absent any applicable statutory nonrecognition provision. Finding no statutory nonrecognition provision applicable, the Sixth Circuit and Judge Cohen concluded that the mortgage exchange transaction was an identifiable event that fixed the amount of loss, which Section 1001(c) of the Code requires to be realized.

tory nonrecognition provision applicable to preclude deductibility of the realized tax losses.[10] There being no conflict among the circuits regarding the realization and recognition of tax losses upon the occurrence of the mortgage exchange transactions, the only issue on which there is a conflict among the circuits is whether Section 165 of the Code precludes the deductibility of realized tax losses.[11]

Notwithstanding that the issue upon which a conflict exists is whether Section 165 precludes the deductibility of an otherwise realized loss, Petitioner devotes almost no space to this issue in its brief. Rather, the principal argument advanced in Petitioner's brief, (Pet. 14-20), is that this Court should reverse the unanimous conclusion of all three courts of appeals that a mortgage loan exchange transaction constitutes a realization event. At its

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[10] Petitioner does not contend that any statutory nonrecognition provision applies in this case to preclude the deductibility of realized losses.

[11] The Sixth Circuit's opinion in *Cottage*, which is Petitioner's only source of conflict among the circuits, explicitly separated its holding that the taxpayer's losses were realized under Section 1001 upon the mortgage exchange transaction from its analysis of whether Section 165 precludes deductibility of the realized losses:

> We believe the loss in this case was technically realized in the sense that an earlier decline in value of the fixed-rate mortgage loans was fixed by an identifiable event—the 'reciprocal sales' transaction. Since there is no Code exception that applies, under § 1001(c) the loss must be recognized. The remaining question is whether an actual loss was sustained for income tax purposes so as to be deductible under § 165. (890 F.2d at 852-53).

heart, this argument is simply a request to this Court to review and reverse the finding that the mortgage loans exchanged were materially different—a conclusion reached by both circuit courts of appeals that addressed the issue, as well as the Tax Court.

Perhaps recognizing that such an issue is clearly not worthy of this Court's attention, Petitioner attempts to blur the fundamental distinction drawn by each court of appeals between the realization requirement of Section 1001 and the requirements of deductibility under Section 165. Thus, Petitioner frames the issue as "[w]hether a financial institution realizes a deductible loss for income tax purposes when it exchanges a group of mortgage loans for a substantially identical group of mortgage loans held by another financial institution." (Pet. I). In doing so, Petitioner makes it appear as if "deductibility" and "realization" are one issue, and that if the mortgages are "substantially identical" for regulatory purposes, they cannot also be "materially different" for tax purposes.

All three of the circuit courts recognized, however, that whether a loss is deductible under Section 165 is a separate issue from whether it is realized under Section 1001. All of the courts agreed that a loss was realized upon the exchange of mortgage loans. Moreover, the two circuits that addressed the issue, as well as the Tax Court, held that the fact that the exchanged loans were considered as substantially identical for regulatory purposes did not mean they were not "materially different" for tax purposes. *See FNMA*, 896 F.2d at 583-84; *San Antonio*, 887 F.2d at 591; *Cottage*, 90 T.C. at 400.

Different policies underlie regulatory and tax accounting.[12] Fulfillment of those policies requires focus on different aspects of the mortgages. The two courts of appeals that applied the materially different standard both held that the mortgage loans exchanged in a Memorandum R-49 transaction were materially different because, among other factors, the loans had different obligors and different properties securing the loans. These differences were irrelevant to the fulfillment of regulatory accounting policies, just as the factors important for those policies were held to be unimportant to the fulfillment of tax policies.

At bottom, the Petitioner's argument is unrelated to the real conflict among the circuits—whether Section 165 precludes the deduction of an otherwise realized loss. Petitioner is simply asking this Court to review and overturn the findings of the Fifth and District of Columbia Circuit Courts of Appeals that the exchanged loans were "materially different." Because there is no conflict on this issue, Respondent submits that such review is unnecessary.

Respondent respectfully submits that, since the issue on which there is a conflict among the circuits only involves the applicability of Section 165 of the Code, if this Court grants a writ of certiorari,[13] it should be limited to the following question:

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[12] This Court has recognized that tax policies and accounting policies differ in stating that "we are mindful that the characterization of a transaction for financial accounting purposes, on the one hand, and for tax purposes, on the other, need not necessarily be the same." *Frank Lyon Co. v. United States*, 435 U.S. 561, 577 (1978).

[13] The Amicus Curiae Brief of the U.S. League of Savings Institutions suggests that if the Court determines to grant a writ of certiorari on the reciprocal mortgage exchange issue, plenary review should not be given to this case because Respondent is a government agency. Respondent's status as a receiver of an insolvent savings and loan may appear to raise the issue whether justiciability is lacking in this case.

There can be little question that this case is justiciable under this Court's decision in *United States v. Nixon*, 418 U.S. 683 (1974). The fact that this case involves issues identical to those presented in other cases pending before this Court demonstrates that it involves "issues of a type which are traditionally justiciable." *Id.* at 696.

Moreover, as receiver, the Resolution Trust Corporation operates as a representative fiduciary that is obligated to maximize the value of the receivership estate for the benefit of beneficiary creditors and stockholders. This fiduciary responsibility "assures that there is that concrete adverseness which sharpens the presentation of issues." *Id.* at 697.

Indeed, the Resolution Trust Corporation, as receiver or potential receiver of many financial institutions to which these issues are relevant, has a larger interest in their outcome than any single private taxpayer. Accordingly, if this Court grants a writ of certiorari on the reciprocal mortgage exchange issue, it should be in this case.

> Whether Section 165 of the Internal Revenue Code precludes the deductibility of losses realized under Section 1001 of the Code upon an exchange of mortgage loans between unrelated financial institutions.

The fact that the petition addresses this issue only tangentially, itself indicates that review of the issue by this Court is unwarranted.

B. Establishment of a Generally Accepted Accounting Principle ("GAAP") that Requires Recordation of Losses Makes Reciprocal Mortgage Transactions Obsolete and Vitiates Petitioner's Argument that the Losses are not Deductible under Section 165.

Petitioner contends that this case merits review because mortgage exchange transactions "were and are common" to financial institutions. (Pet. 11). To the contrary, Respondent respectfully submits that mortgage exchange transactions are now obsolete, having been nullified by establishment of a generally accepted accounting principle ("GAAP") reversing the nonrecordation rule in Memorandum R-49 and by a new federal law requiring conformity of regulatory accounting with GAAP.

Federal law now requires that the nation's savings and loans utilize GAAP for regulatory as well as financial accounting purposes. Section 301 of FIRREA, (*Supra*, 3-4). In 1980 when Memorandum R-49 was issued for regulatory accounting purposes, there was no authoritative GAAP interpretation regarding whether gains and losses were required to be recorded for financial accounting purposes upon a reciprocal mortgage loan sale. However, today, GAAP definitively requires financial institutions to record losses upon a mortgage exchange transaction of the type described in Memorandum R-49 in which there are different primary obligors on the mortgage loans.[14]

[14] The Accounting Standards Division of the American Institute of Certified Public Accountants ("AICPA") issued Statement of Position 90-3 on February 13, 1990, entitled "Definition of the Term *Substantially the Same* for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position." Statement of Position 90-3 amended the AICPA's

Now that GAAP authoritatively requires recordation of losses upon a Memorandum R-49 mortgage exchange and federal law requires regulatory accounting to conform to GAAP, there is no longer any regulatory or financial accounting difference between reciprocal mortgage loan exchanges and sales of mortgage loans for cash. In each case, a transferor financial institution must record losses for regulatory and financial accounting purposes.

As found by the Fifth Circuit below, the Bank Board intended reciprocal mortgage loan sales to be an alternative to cash sales because the former, but not the latter, would not require immediate recordation of losses for regulatory accounting purposes. *See San Antonio*, 887 F.2d at 580-81. Now that GAAP has overridden Memorandum R-49 and requires recordation of losses upon a mortgage exchange transaction, there is no regulatory accounting advantage

Industry Audit Guide, Audit of Banks (1983) and AICPA's *Audit and Accounting Guide, Savings and Loan Associations* (1985). Statement of Position 90-3 establishes GAAP for exchanges of debt instruments, including reciprocal mortgage loan sales or other mortgage exchange transactions. Statement of Position 90-3 requires losses to be recorded unless the exchanged debt instruments meet six criteria establishing them as "not substantially the same." One criteria pertinent to reciprocal mortgage loan exchanges is that the debt instruments must have the same primary obligor, unless the instruments are guaranteed on the same terms by a sovereign government or government-sponsored enterprise or agency. Statement of Position 90-3 expressly provides that "the exchange of pools of single-family loans would not meet this criterion because the mortgages comprising the pool do not have the same primary obligor, and would therefore not be considered *substantially the same*." *Id.* ¶ 13 n.1 (emphasis in original). Accordingly, Statement of Position 90-3 reverses the nonrecordation result of Memorandum R-49.

to engaging in a reciprocal mortgage loan sale rather than a straight sale for cash. Thus, in the future, savings and loans are not likely to engage in mortgage exchange transactions. Consequently, a decision of this Court in this case will have no continuing application to financial institutions.

As noted, GAAP now requires that losses be recorded upon a reciprocal mortgage exchange because the mortgages have different primary obligors and are considered "not substantially the same." This new GAAP requirement undermines the basic premise of the Petitioner's argument that the losses are not deductible. Blurring the distinction between "realization" and "deductibility," Petitioner argues that the substantially identical standard for financial accounting purposes and the materially different requirement for realization under Section 1001 are "essentially the same inquiry into economic substance," (Pet. 19), and that a loss is not deductible under Section 165 if the transaction lacks economic substance, (Pet. 15 n.12). Thus, Petitioner states that "the Bank Board's expert opinion that mortgages satisfying the Memorandum R-49 criteria are 'substantially identical' is highly relevant to the tax question here." (Pet. 19-20).

Assuming arguendo (and contrary to the reasoning of each court of appeals) that the requirements of realization under Section 1001 and of economic substance under Section 165 collapse into a common inquiry as to whether the mortgage loans are substantially the same or materially different, the establishment of an authoritative GAAP pronouncement is entitled to greater weight than the Bank Board's promulgation of a regulatory accounting rule in the absence of authoritative GAAP treatment. By requiring that regulatory accounting generally conform to GAAP, Congress has confirmed that greater weight should be given to GAAP than to a regulatory accounting rule. *See* § 301 of FIRREA, (*Supra*, 3-4).

Thus, GAAP's recognition that mortgage loans with different primary obligors are not substantially the same establishes, in the terms of Petitioner's argument, that the mortgage exchange transactions had economic substance and losses realized upon such transactions are deductible under Section 165.

C. The Narrow Issue of Deductibility of Realized Losses Under Section 165 of the Code Has Such a Narrow Scope That Review is Not Merited.

Although the circuits have differed in their applications of Section 165 to mortgage exchange transactions, the scope of Section 165 under either approach is so narrow that review by this Court of the appropriate standard would have little significance to the administration of the tax laws.

Section 165 of the Code allows the deduction of losses sustained during the taxable year for which no offsetting insurance or other compensation is received. Treasury Regulations § 1.165-1(b) provides:

> *Nature of loss allowable.* To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and § 1.165-11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and

> not mere form shall govern in determining a deductible loss.

The Sixth Circuit, in *Cottage*, ruled that the mortgage exchange transaction lacked economic substance so that the loss realized under Section 1001 was not deductible under Section 165. However, the Sixth Circuit's analysis depended critically upon the treatment of the mortgage exchange transaction for financial accounting purposes:

> [b]ecause [the taxpayer] received a substantially identical pool of mortgages in exchange, . . . and did not record the decline on its books, it was not 'poorer to the extent of the loss claimed.' *Shoenberg v. Commissioner*, 77 F.2d 446, 449 (8th Cir.), *cert. denied*, 296 U.S. 586 (1935). (890 F.2d at 855).[15]

With the recent pronouncement of an authoritative GAAP position that the mortgage loans exchanged in a reciprocal sales transaction are not substantially the same, the Sixth Circuit's analysis has little vitality. Petitioner's brief suggests no other rationale for the

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[15] The Sixth Circuit's reliance on *Shoenberg* was misplaced. *Shoenberg* involved the 1930 tax year and predated Treasury Regulations § 1.165-1(b) and the statutory wash sale rule (Code Section 1091). In *Shoenberg*, the appeals court disallowed a loss deduction where an individual sold through its broker shares of common stock of several publicly traded corporations upon instructions that the broker cause an alter ego corporation to repurchase, within a matter of days, the same number of shares of the same corporations at exactly the same net price (after commissions to the broker). The entire transaction lacked economic substance because the taxpayer repurchased identical property in a transaction that lacked the bona fides of a true sale.

Sixth Circuit's application of Section 165 to preclude deduction of realized losses. When correctly interpreted, Section 165 has such narrow applicability that one cannot readily foresee situations in which a decision by this Court in this case would have effect.

Section 165 and Treasury Regulations § 1.165-1(b), as correctly interpreted by both the Fifth Circuit, in *San Antonio*, and the District of Columbia Circuit, in *FNMA*, are "aimed at transactions that taxpayers enter to *generate* losses that would otherwise not exist." *FNMA*, 896 F.2d at 584. That is, Section 165 precludes the deductibility of manufactured losses in sham transactions. Section 165 has heretofore never been held to preclude the deductibility of real economic losses that are realized in bona fide, closed transactions.[16]

The losses realized upon the occurrence of a Memorandum R-49 transaction were not generated by that transaction, but were real economic losses, attributable to mortgage loans made in the ordinary course of business, and caused by increases in market rates of interest. Such losses were realized through bona fide transactions between unrelated financial institutions acting at arms'-length to exchange discrete mortgage loans or loan participations on a basis reflecting the fair market values of such property. The fact that, in the absence of an authoritative GAAP pronouncement, the Bank Board did not require the

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[16] All of the loss disallowance cases relied upon by the Sixth Circuit in *Cottage* also involved sham transactions. *See Cottage*, 890 F.2d at 853-54, *citing Horne v. Commissioner*, 5 T.C. 250 (1945); *Davis v. Commissioner*, 585 F.2d 807 (6th Cir. 1978), *cert. denied*, 440 U.S. 981 (1979); and *Keats v. United States*, 865 F.2d 86 (6th Cir. 1988).

losses to be recorded for regulatory accounting purposes does not make them any less real. Indeed, it is because the savings and loan institutions were poorer by the amount of the losses claimed that the Bank Board promulgated Memorandum R-49. (Pet. 4 n.2). Each of the circuit courts concluded that the mortgage exchange transactions were bona fide, closed and completed transactions, which required realization of the economic losses for federal income tax purposes. Given this consensus conclusion, now buttressed by GAAP's requirement that the economic losses be recorded, Section 165 provides no basis for the denial of deductions of realized losses on reciprocal mortgage exchanges.[17]

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[17] At bottom, the Sixth Circuit's conclusion that no loss was sustained under Section 165 can only be explained by its view that there was no purpose to the mortgage exchanges other than the reduction in taxes. While in certain contexts of the income tax laws, a taxpayer's motivation may be relevant, Section 165 is not one of them. The economic substance required to sustain a loss under Section 165 does not refer to a taxpayer's subjective motivation, but only to an objective determination that the taxpayer has suffered an actual economic loss. Section 165 certainly does not prevent realization of an otherwise real loss because the taxpayer chooses the timing of the event that realizes such loss for federal income tax purposes. If it did, literally millions of dollars of losses could be disallowed each December because taxpayers choose to sell unprofitable stock investments in order to claim a deduction on their current year's tax returns.

Accordingly, even when construing the facts of the mortgage exchange transactions as being solely tax motivated, the Fifth Circuit and the District of Columbia Circuit held that the transactions had economic substance for purposes of deducting realized tax losses under Section 165. *See FNMA*, 896 F.2d at 584 and *San Antonio*, 887 F.2d at 592. Petitioner presents no reason or authority why this Court should require a non-tax business purpose as a predicate to deduction of real business losses realized upon a bona fide exchange of property.

In sum, Petitioner focuses not on the conflict among the courts of appeals, but on what Petitioner perceives to be an erroneous application of Section 1001 to the facts by the courts below. If such an issue ever justifies certiorari in the absence of a conflict, it is not in this case where changes in the law have eliminated the future use of the transaction in question, and a decision by this Court would have little precedential effect in other areas.

II. Review is not Warranted on the Issue Whether Certificate of Deposit Premature Withdrawal Penalties Constitute "Discharge of Indebtedness" under Section 108 of the Code.

The question whether certificate of deposit premature withdrawal penalties constitute discharge of indebtedness income under Section 108 of the Code has no continuing significance to the income tax laws because Congress, in 1986, repealed the applicability of Section 108 to solvent debtors and modified Section 108's applicability to insolvent debtors. Even with respect to residual pre-1986 cases, because resolution of the issue turns on a highly fact-specific characterization of CD agreements, this Court's resolution of the issue would have little or no relevance to the application of Section 108 to other types of indebtedness. Since no tax policies of general and continuing applicability are at issue, the second question presented in this case does not merit review by this Court.

A. Repeal of Section 108 of the Code Eliminates Any Importance of this Case.

Since this Court's seminal decision, in 1931, in *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), it has been settled in the tax law that a debtor may realize income by having its indebtedness discharged at less than its face or accrued amount. Between 1942 and 1986, Section 108 of the Code and predecessor provisions permitted all corporate taxpayers, whether or not insolvent or financially troubled, to ameliorate the effects of income realization from the discharge of indebtedness by reducing the tax basis of their depreciable assets.[18] Thus, the income from discharge of indebtedness could be deferred, at the election of a taxpayer, until realized as a result of the depreciation or disposition of the reduced basis assets.[19] In

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[18] Congress limited the original predecessor to Section 108, § 22(b)(9) of the Internal Revenue Code of 1939, to corporations that were in "unsound financial condition." In 1942, Congress removed the requirement that a corporation be of unsound financial condition. The legislative history of the 1942 modification to the predecessor of Section 108 establishes that Congress intended the benefits of Section 108 to be available to all corporations. *See Centennial Sav. Bank v. United States*, 887 F.2d 595, 602 (5th Cir. 1989), *petition for cert. filed*, No. 89-1926, *citing* S. Rep. No. 1631, 77th Cong., 2d Sess. 114 (1942).

[19] For example, assume a taxpayer elects to reduce the tax basis of an asset having a depreciable life of ten years and no salvage value from its cost of $1 million to $500,000 in order to avoid including in its current taxable income $500,000 realized as the result of discharge of indebtedness. In that event, the taxpayer's taxable income will be increased in each of the next ten years by the difference between the $100,000 depreciation deduction that would have been allowed in each such year had basis not been reduced, and the $50,000 depreciation deduction that will actually be allowed. Thus, the effect of such election

1986, Congress repealed Section 108's applicability to solvent debtors and restricted the deferral provision to bankrupt or insolvent debtors. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 822(a), 100 Stat. 2085, 2373. Thus, the issue in this case has continued vitality only with respect to cases that remain open under the statute of limitations for discharges of indebtedness prior to January 1, 1987.[20]

B. This Issue Is Highly Fact-Specific and Presents No General Issues of Tax Policy.

This Court's review of the discharge of indebtedness issue would also have minimal significance because of the highly fact-specific nature of the statutory construction required of a court. As applied to corporate debtors for more than 40 years, Section 108

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is simply to spread the reporting of the $500,000 in discharge of indebtedness income over the ensuing ten years.

[20] Even as to insolvent financial institutions, whether CD premature withdrawal penalties give rise to discharge of indebtedness income will generally have no effect on the taxpayer's tax liabilities or tax attributes. As amended in 1986, Section 108(b) now requires an insolvent debtor to take discharge of indebtedness income into account first by reducing its net operating loss, rather than reducing the basis of its property. The effect of reducing its net operating loss is exactly the same as if section 108 had been fully repealed and discharge of indebtedness income were includable in an insolvent debtor's gross income. This is so because such an inclusion of income would generally merely reduce the size of the insolvent debtor's net operating loss. *See also* Section 7507 of the Code (exempting insolvent banks and savings and loans from tax, even if the financial institutions have a particular net positive income for a particular tax year). Thus, with respect to insolvent financial institutions that issue CDs subject to premature withdrawal penalties, Section 108's continued applicability is more theoretical than real.

was expressed in stark terms devoid of a definition of "discharge of indebtedness." Despite the absence of statutory or regulatory definitions, Section 108 and its predecessors were relied upon by taxpayers and respected by the Internal Revenue Service. Although disputes as to the application of Section 108 have arisen, resolutions of these cases turned on highly fact-specific conclusions rather than any generally applicable tax policies or established case law standards or definitions. In applying Section 108, both the Tax Court, in *Colonial Savings Association v. Commissioner*, 85 T.C. 855 (1985), *aff'd*, 854 F.2d 1001 (7th Cir. 1988), *cert. denied*, 109 S.Ct. 1556 (1989), and the Fifth Circuit, in the case below, quoted a noted commentator who called Section 108 " '[o]ne of the murkiest pools of obscurity in the tax law,' " quoting Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 Tax L. Rev. 225, 286 (1959), 85 T.C. at 861 n.10; 887 F.2d at 609 n.9.

Significantly, this Court did not see occasion to clarify standards for the application of Section 108 during the more than 40 years prior to its substantial repeal in 1986. There is even less need now. The instant case, involving an issue that is fundamentally factual in origin and isolated in its consequences, presents no compelling reasons of tax policy or tax administration to do so.[21]

[21] The tax stakes from the applicability of Section 108 to CD premature withdrawal penalties are significantly less than the $128 million in tax liabilities that Petitioner claims are at stake in pending cases. The $128 million figure represents taxes on income excluded from current recognition under Section 108. However, such income is not permanently excluded and will be taxed as income realized as a result of reduced depreciation deductions or disposition of reduced basis assets. Thus, the government's economic stake in the characterization of CD premature withdrawal penalties is limited to a speedier collection of tax. In referring to the total volume of CD premature withdrawal penalties outstanding, Petitioner significantly overstates the true tax stakes in this case.

C. The Fifth Circuit Correctly Decided the Issue in This Case.

Both the Fifth Circuit, in this case below, and the Seventh Circuit, in *Colonial Savings*, defined the Section 108 issue to be whether the premature withdrawal penalty should be characterized as an integral part of the CD obligation, or as a separate obligation. Resolution of this issue turns on a factual assessment of the relationship between the premature withdrawal penalties and the CD obligations. Court opinions applying Section 108 in other contexts provide little guidance. Similarly, a decision in this case would have little precedential value in applying Section 108 in other contexts.

On the merits, the Fifth Circuit's analysis is considerably more compelling. As noted by the court below, the "CD [premature withdrawal] penalty is not an obligation independent of the creditor/debtor relationship." *Centennial*, 887 F.2d at 605. Rather, a depositor's premature withdrawal of the principal and accrued interest of a CD is simply the exercise of a contractual right to shorten the term of the obligation in return for a reduction in the amount of such obligation.

It is undisputed that both the principal amount of a CD and the interest accrued up to the date of withdrawal or maturity represent indebtedness of the

financial institution to the depositor. *See Colonial Savings*, 85 T.C. at 864 n.14. The early withdrawal penalty, which was prescribed by federal regulations, was effectuated by the depositor's forfeiture of interest for prescribed periods depending upon the original term of the CD. *See* 12 C.F.R. § 1204.103 (1981). (*Supra*, 2-3). Thus, not only were the premature withdrawal penalties integral parts of the CDs, they constituted direct cancellation of a portion of the principal and accrued interest owed under the terms of the CDs. On these facts, the Fifth Circuit's conclusion that premature withdrawal penalties represent "discharge of indebtedness" is unassailable.

CONCLUSION

For the foregoing reasons, Respondent respectfully requests that the petition for a writ of certiorari be denied. However, if a writ of certiorari is granted with respect to the reciprocal mortgage exchange issue, Respondent respectfully requests that it be granted solely with respect to the restated question set forth herein.[22]

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[22] The Acting Solicitor General has authorized the filing of this response.

Respectfully submitted,

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REPLY

BRIEF

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No. 89-1928

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In the Supreme Court of the United States

OCTOBER TERM, 1990

UNITED STATES OF AMERICA, PETITIONER

v.

CENTENNIAL SAVINGS BANK FSB
(RESOLUTION TRUST CORPORATION, RECEIVER)

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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BEST AVAILABLE COPY

In the Supreme Court of the United States

OCTOBER TERM, 1990

No. 89-1926

UNITED STATES OF AMERICA, PETITIONER

v.

CENTENNIAL SAVINGS BANK FSB
(RESOLUTION TRUST CORPORATION, RECEIVER)

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

Respondent's primary objection (Br. in Opp. 9-17) is to the description of the first question presented in the government's petition. Respondent asserts that, rather than presenting the broad question of the deductibility of losses claimed by financial institutions upon the exchange of substantially identical mortgage loans, the petition should have presented only the much narower question of whether Section 165 of the Code precludes such a deduction (see Br. in Opp. 16-17). Respondent then argues that the narrower

question that it would substitute lacks sufficient importance to warrant certiorari (see *id.* at 21-25). This objection plainly is misconceived.

As we explained in our petition (at 11-13), the issue presented in this case (and in the other "mortgage swap" cases that have been decided by the courts of appeals) is whether the mortgage exchanges give rise to deductible losses. There is a direct conflict in the circuits on this question, with the Fifth and District of Columbia Circuits holding that the exchanges do give rise to a deductible loss and the Sixth Circuit holding that they do not. The courts addressing this question have been required to consider alternative theories—arising under both Section 165 and Section 1001 of the Code—for denying or upholding the claimed loss deductions, and they have reached divergent conclusions. See, *e.g.*, Pet. App. 47a-54a (deduction disallowed because mortgages do not satisfy "materially different" requirement of Section 1001), rev'd, Pet. App. 8a-9a; *San Antonio Savings Ass'n* v. *Commissioner*, 887 F.2d 577, 578 (5th Cir. 1989) (deduction allowed because mortgages do satisfy "materially different" requirement of Section 1001), petition for cert. pending, No. 89-1928; *First Federal Savings & Loan Ass'n* v. *United States*, 694 F. Supp. 230, 238 (W.D. Tex. 1988) (deduction allowed because Section 1001 does not have "materially different" requirement), aff'd on other grounds, 887 F.2d 593 (5th Cir. 1989), petition for cert. pending, No. 89-1927; *Cottage Savings Ass'n* v. *Commissioner*, 890 F.2d 848 (6th Cir. 1989) (deduction disallowed because no loss sustained under Section 165), rev'g 90 T.C. 372 (1988), petition for cert. pending, No. 89-1965.

There is no logic to respondent's contention that this Court should limit its review here to determining

the correctness of the Sixth Circuit's interpretation of Section 165 in *Cottage Savings*, because that is the analytical source of the conflict in the circuits on the deductibility issue, while leaving open the other subissues that have been litigated in the lower courts.[1] That approach would lead to an incomplete resolution of the question presented here, with the possibility that other courts in the future would reach a result contrary to that reached by this Court because all of the relevant arguments would not have been presented to this Court. Accordingly, we submit that the petition correctly presents for this Court's consideration the ultimate issue that is the subject of considerable litigation in the lower courts, and on which the courts of appeals are in conflict—namely,

[1] Even the premise of respondent's suggestion—namely, that the interpretation of Section 165 is the only point on which the Sixth Circuit disagreed with the Fifth Circuit—is erroneous. The Sixth Circuit noted that it departed from the view of other courts on the interpretation of Section 1001 as well, agreeing instead with the concurring judges in the Tax Court that Section 1001(c) does not require that exchanged property be materially different in order to allow recognition of gain or loss upon the exchange. See 890 F.2d at 852; 90 T.C. at 403-404 (Cohen, J., concurring). And, while the Fifth Circuit explicitly held that the mortgages exchanged in Memorandum R-49 transactions were "materially different," the Sixth Circuit indicated its view that there was a "lack of a material difference" between the exchanged mortgages (890 F.2d at 855). Thus, contrary to respondent's suggestion, the courts of appeals are in disarray on the correct interpretation of the realization rules of Section 1001. In any event, there is no reason for this Court to restrict the government to arguing only the theory that was accepted by the Sixth Circuit; the confusion in the lower courts with respect to the treatment of these mortgage exchange transactions can best be alleviated by this Court's consideration of all the relevant arguments.

whether the mortgage exchange transactions give rise to a deductible loss. As explained in our petition (at 13; see also U.S. League of Savings Institutions Amicus Br. 4), that issue is being litigated in many cases involving large sums of money, and it warrants this Court's attention.[2]

For the foregoing reasons, and those stated in our petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

JOHN G. ROBERTS, JR.
Acting Solicitor General *

SEPTEMBER 1990

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[2] Respondent states that a change in the accounting standards for the savings and loan industry has rendered mortgage exchanges "obsolete" (Br. in Opp. 18) because there is no longer any "regulatory accounting advantage to engaging in a reciprocal mortgage loan sale rather than a straight sale for cash" (*id.* at 19-20); hence, respondent argues, the question presented does not merit review by this Court. Respondent appears to overstate the effect of this accounting change: first, the change contains an exception for mortgages guaranteed by a government or government-sponsored agency (see *id.* at 19 n.14); second, respondent assumes that, apart from regulatory accounting, there will never be any advantage to proceeding by way of a mortgage exchange rather than a sale. We recognize, however, that, in light of changes in the economy and in the savings and loan industry, the extent to which this issue will arise for future years is a matter of speculation. Rather, as we stated in our petition (at 13), the demonstrable importance of this issue lies primarily in the abundance of cases that are already being litigated all over the country, with hundreds of millions of dollars at stake. Whether or not the issue will be important in the future, it plainly is important *now*.

* The Solicitor General is disqualified in this case.

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AMICUS CURIAE

BRIEF

Nos. 89-1926; 89-1927; 89-1928

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In The

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United States of America,

v. *Petitioner,*

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(Resolution Trust Corporation, Receiver)

United States of America,

v. *Petitioner,*

First Federal Savings and Loan Association of Temple

Commissioner of Internal Revenue

v. *Petitioner,*

San Antonio Savings Association And Subsidiaries
(Resolution Trust Corporation, Receiver)

Amicus Curiae Brief Of The U.S. League Of Savings Institutions Filed In Opposition To The Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

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QUESTION PRESENTED

Whether a loss from an exchange of mortgage loans involving a complete transfer of ownership rights by both parties can be disallowed as not sustained under Section 165 of the Internal Revenue Code if the loss is realized and recognized within the meaning of Section 1001 of the Code.

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Amicus Curiae Brief Of The U.S. League Of Savings Institutions Filed In Opposition To The Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

PURPOSE OF THIS AMICUS CURIAE BRIEF

This brief is submitted as a Brief in Opposition, pursuant to Rules 15 and 37 of this Court's Rules, in three cases from the United States Court of Appeals for the Fifth Circuit for which the Acting Solicitor General on

behalf of the United States (petitioner) has requested a writ of certiorari.[1] This brief is submitted on behalf of the respondent taxpayers.

The United States League of Savings Institutions ("U.S. League"), as amicus curiae, respectfully requests that the petitions for writ of certiorari sought by the petitioner be denied. If, however, the Court decides to grant review to the tax issue involving the deductibility of losses from exchanges of mortgage loans, this brief is intended to serve two purposes:

1) To correct petitioner's statement of the Question Presented with regard to the issue involving exchanges of first mortgage residential loans; and

2) To suggest to the Court which of the cases in the three appeals courts involving exchanges of loan portfolios should receive plenary review.[2]

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[1] The parties in the three above referenced cases have all consented in writing to the filing of this brief amicus curiae. *See* Sup. Ct. R. 37. The written consents have been filed with the clerk of the Court. The Fifth Circuit cases are *San Antonio Savings Association v. Commissioner*, 887 F.2d 577 (5th Cir. 1989); *Centennial Savings Bank v. United States*, 887 F.2d 595 (5th Cir. 1989); and *First Federal Savings and Loan Association of Temple v. United States*, 887 F.2d 593 (5th Cir. 1989).

[2] This brief also addresses petitioner's petition for a writ of certiorari in *Federal National Mortgage Association v. Commissioner*, 896 F.2d 580 (D.C. Cir. 1990) ("FNMA") filed in this Court on June 19, 1990; and the taxpayer's petition for a writ of certiorari on the mortgage exchange issue in *Cottage Savings Association v. Commissioner*, 890 F.2d 848 (6th Cir. 1989) ("Cottage Savings").

INTEREST OF THE U.S. LEAGUE OF SAVINGS INSTITUTIONS AS AMICUS CURIAE

The United States League of Savings Institutions is the nationwide trade association representing the interests of savings institutions. Those institutions serve the nation's housing finance, savings and related financial service needs. Its membership as of June 28, 1990, includes 2,374 savings and loan, savings bank and cooperative bank institutions from every State, the District of Columbia, Puerto Rico, the Virgin Islands and Guam; 30 savings and loan holding companies; 165 associate members (typically law, accounting and other supplier firms to the industry); and 60 State and regional organizational members.[3]

The purposes of the U.S. League are to encourage a political, economic and social climate in which savings institutions can operate profitably, so that member institutions can effectively serve the financial needs of the American public. The U.S. League represents the collective views of its members before Congress, the executive branch of government, federal regulators and other

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[3] The nationally elected officers for 1990 are Kenneth D. Seaton of Hancock, MI, Chairman, and Robert B. O'Brien, Jr. of Newark, NJ, Vice Chairman. Principal staff include Frederick L. Webber, President and Chief Executive Officer; Brian Smith, Executive Vice President & Deputy, Chicago Office; Denis O'Toole, Executive Vice President-Government Affairs; and Philip Gasteyer, Executive Vice President & General Counsel. The League's office locations are 1709 New York Avenue, N.W., Washington, D.C. 20006, and 111 East Wacker Drive, Chicago, IL 60601.

appropriate bodies. On occasion, it participates as *amicus curiae* in litigation of widespread interest and significance to its membership.

Many members of the U.S. League are involved in pending tax audits and litigation in U.S. Tax Court and other courts around the country involving tax deductions from exchanges of first mortgage residential loans. This is an issue of real magnitude for the entire thrift industry as it involves 96 cases and the interest on $419 million in taxes. The principal amount of these taxes is merely deferred from the deduction year to later years.

The U.S. League filed *amicus curiae* briefs on the mortgage exchange issue, which is the subject of the instant brief, in the Fifth Circuit in *San Antonio Savings Association v. Commissioner*, in the U.S. Tax Court proceedings involving that case, and also in the U.S. Tax Court proceedings involving Cottage Savings Association and the Federal National Mortgage Association, which cases are the subjects of separate petitions for a writ of certiorari before this Court.

COUNTERSTATEMENT OF THE QUESTION PRESENTED

In his petitions in the *San Antonio*, *Centennial* and *First Federal* cases, petitioner states the Question Presented as follows:

> "Whether a financial institution realizes a deductible loss for income tax purposes when it exchanges a group of mortgage loans for a substantially identical group of mortgage loans held by another financial institution."

This formulation of the issue is incorrect for three reasons.

1. The question of whether a financial institution "realizes" its loss from exchanging groups of mortgage loans is not in conflict among the three Circuit Courts which have addressed this tax deduction question. The Fifth, Sixth and District of Columbia Circuits all agree that each taxpayer *realized* their respective losses under Section 1001(a) and *recognized* those losses under Section 1001(c) of the Internal Revenue Code.[4] If this Court chooses (as we believe it should) to concentrate on the

---

[4] The Sixth Circuit stated in *Cottage Savings*:

> "We believe the loss in this case was technically realized in the sense that an earlier decline in value of the fixed-rate mortgage loans was fixed by an identifiable event – the 'reciprocal sales' transaction. Since there is no Code exception that applies, under § 1001(c) the loss must be recognized." 890 F.2d at 852.

Similarly, the Fifth Circuit stated in *San Antonio*:

> "We uphold the finding of the tax court allowing SASA the deduction of $14,956,898 under the Internal Revenue Code as loss realized through the exchange of materially different property." 887 F.2d at 593.

All three appeals courts also agreed that a business purpose is not required in order for a seller of property which has declined in market value to sell or exchange the asset in order to realize his loss for tax purposes. The U.S. Tax Court unanimously held for the taxpayers on the realization issue and rejected all of the Commissioner's arguments.

Unless otherwise indicated, statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.) as in effect for the years at issue ("Code").

area of conflict among the appeals courts concerning deductibility of the losses, realization of the loss is not the technical matter which needs resolving by this Court. Petitioner is merely seeking to prolong litigation over tax realization rules in still another forum after having lost that battle decisively in all three appellate courts involved here.

The Question Presented on which the Sixth Circuit disagrees with the Fifth Circuit and District of Columbia Circuit concerns only the role of Section 165 of the Code in allowing or disallowing the losses in these cases. The Section 165 issue is discussed at pages 9-10, below.

2. Even as a statement of the realization issue involved in exchanges of loan portfolios, petitioner's formulation of the Question Presented is question-begging in referring to the mortgages received as "substantially identical." In his various petitions to this Court, petitioner does not argue or establish that "substantial identity" between or among the mortgages is a relevant legal standard under the *realization* provisions of Section 1001 and the related regulations.[5] The basic realization issue

[5] A "substantially identical" test appears in the loss disallowance provisions of § 1091 (relating to so-called wash sales). The Tax Court squarely rejected the applicability of § 1091 to exchanges of mortgage loans in *FNMA v. Commissioner*, 90 T.C. 405, 425 (1988), *aff'd on other grounds*, 896 F.2d 580 (D.C. Cir. 1990). The Commissioner thereafter ceased making any § 1091 argument in any of these cases. Petitioner does not invoke § 1091 in any of his petitions in this Court on the mortgage exchange issue. In any event, the Commissioner has long ruled that different issuers of stock or securities prevent substantial identity under the wash sale provision of § 1091. *See, e.g.*, Rev. Rul. 59-44, 1959-1 C.B. 205; *see also Hanlin v. Commissioner*, 108 F.2d 429 (3rd Cir. 1939), *aff'g*, 38 B.T.A. 811 (1938).

framed by both the taxpayers and the Commissioner of Internal Revenue ("Commissioner") in the three appeals courts, as well as in the lower courts in all of these cases, is whether the mortgages transferred and received were "materially different" from each other "in kind or in extent" within the meaning of Treas. Reg. § 1.1001-1(a) or whether gain or loss is realized directly under Section 1001. The Fifth Circuit, Sixth Circuit and District of Columbia Circuits all agree that the losses in each of the cases were realized and recognized within the meaning of Section 1001. All three appeals courts based that conclusion on their view that the losses were *realized* under the "material difference" standard by reason of the fact of different debtors and collateral on both sides of the exchange; and that the realized losses were *recognized* under Section 1001(c), there being no nonrecognition provision elsewhere in the Code overriding that provision. None of the three appeals courts tested the exchanges by a "substantially identical" standard under Section 1001, or held that the financial accounting label used in

Memorandum R-49 of the Federal Home Loan Bank Board is legally relevant to realization of gain or loss under the tax law.[6]

Petitioner's reference to "substantial identity" in his version of the Question Presented is nothing other than a disguised contention that the regulatory accounting rule in Memorandum R-49 (describing the mortgages received as "substantially identical") controls realization or non-realization of gain or loss under the tax code (Section 1001). That specific proposition, however, is one on which all three appeals courts rejected the Commissioner's argument. This Court has long ruled that financial

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[6] The Government's Petition in *Centennial* misstates the holding of the Fifth Circuit in *San Antonio* and *Centennial*. The Government states:

> "In this case (and in its decision in the lead case of *San Antonio Savings Ass'n v. Commissioner*, 887 F.2d 577 (1989)), the Fifth Circuit has held that pools of mortgages *regarded as 'substantially identical' by the parties* and by the Federal Home Loan Bank Board under Memorandum R-49 are nonetheless 'materially different' for tax purposes." (Govt. *Centennial* Pet. 11) (emphasis added).

The taxpayers in both *Centennial* and *San Antonio* did not "regard" the mortgage groups as substantially identical for any purpose. For regulatory accounting purposes they simply complied with the criteria of Memorandum R-49. Their subjective views were immaterial for R-49 purposes.

The taxpayers also had no occasion to "regard" the groups as substantially identical for income tax purposes, because (as we have noted) no statutory provision or regulation under the Internal Revenue Code established "substantially identical" as a tax test of realization, recognition, or allowance of the deduction. None of the three Fifth Circuit decisions states that the taxpayers "regarded" the mortgage groups as substantially identical to each other.

accounting rules serve different purposes than tax rules, and do not determine tax results. *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 542-544 (1979).[7]

3. The Sixth Circuit differed from the other two circuits with regard to interpreting and applying Section 165 (relating to the general allowance of loss sustained during the taxable year and not compensated for by insurance or otherwise). In a relatively short and non-analytic discussion, the Sixth Circuit held that a loss can be treated as not "sustained" for purposes of Section 165 even though it is realized and recognized under Section 1001, and that Cottage Savings did not sustain its loss because it did not "change its economic position" as a result of the exchange. The Sixth Circuit adopted the notion that in order to sustain a loss for tax purposes, a taxpayer must be economically "poorer" after the exchange than he was before the exchange. The court

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[7] The Fifth Circuit held that mortgages can be "materially different" for tax purposes while being "substantially identical" within the meaning of Memorandum R-49 for regulatory accounting purposes. *San Antonio*, 887 F.2d at 591. Further support for this proposition, and specific examples, will be discussed in the substantive briefs the U.S. League plans to file on the mortgage exchange issue.

If this Court should decide to review whether each taxpayer *realized* his loss within the meaning of § 1001, the Court should consider whether District Judge Smith in *First Federal* and concurring Judge Cohen in the U.S. Tax Court provide a correct analysis that Treas. Reg. § 1.1001-1(a) does not have significance independent of § 1001 of the Code. In this view, under common law concepts, gain or loss is realized from an exchange unless the exchanged properties represent the same property rights.

reasoned that Cottage Savings was not "poorer" because it received loan receivables which were "substantially identical" to those sold, basing that conclusion on the terminology of the Federal Home Loan Bank Board's Memorandum R-49. The unexamined assumption is that regulatory accounting labels control the "sustaining" of loss under Section 165.[8] The Fifth Circuit, by contrast, held that Section 165 requires only that the losses resulted from a bona fide decline in market value of the mortgages (on account of an increase in new mortgage interest rates) and were fixed by a complete transfer of ownership rights between unrelated parties. There is no "substantial identity" test under Section 165, according to the Fifth Circuit. See *San Antonio*, 887 F.2d at 592-93.

In light of these two different interpretations, the real issue is whether the losses can be disallowed *under Section 165*.[9]

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[8] The Sixth Circuit appears to have been unaware of the express provisions of Treas. Reg. § 1.1001-1(a), which state that if a sale or exchange is considered to involve materially different property, the gain or loss "is treated as income or as loss sustained."

[9] The technically correct path to deducting the losses, we believe, is that a loss must first be sustained under § 165 in the sense of involving a bona fide transfer of full ownership rights to property, and *then* if an exchange is involved, the loss must be realized and recognized under § 1001. The § 165 tests precede rather than follow the realization test under § 1001. Unlike certain tax shelter cases, the losses here were not manufactured by the taxpayers to obtain tax deductions; the losses resulted from an increase in home mortgage interest rates during the late 1970s and early 1980s and the corresponding devaluation of loans held in thrift portfolios.

Since the meaning and application of Section 165 is the only legal issue over which the three appeals courts disagreed on exchanges of loan portfolios, we submit the Question Presented is stated more accurately as follows:

> Whether a loss from an exchange of mortgage loans involving a complete transfer of ownership rights by both parties can be disallowed as not sustained under Section 165 of the Internal Revenue Code if the loss is realized and recognized within the meaning of Section 1001 of the Code.

SELECTION OF CASES FOR PLENARY REVIEW

This is one of the relatively few situations where multiple petitions are before this Court on the identical issue. The various decisions on the deductibility of losses from exchanges of loan portfolios present a "menu" of contexts, lower court decisions and judicial approaches. These decisions can be summarized as follows:

FIFTH CIRCUIT	FEATURE	CIRCUIT DECISION
First Federal	Follows *San Antonio* on mortgage exchange issue	Affirms U.S. District Court, W.D. Texas
San Antonio (in receivership)	Principal opinion in Fifth Circuit	Affirms Tax Court
Centennial (in receivership)	Follows *San Antonio* on mortgage exchange issue. Also involves penalty income issue.	Reverses U.S. District Court, N.D. Texas
SIXTH CIRCUIT		
Cottage	Agrees loss is realized and recognized, but disallows deduction under § 165	Reverses Tax Court
D.C. CIRCUIT		
FNMA	Follows rationale in *San Antonio*	Affirms Tax Court

In his petitions for certiorari in the Fifth Circuit cases, as well as in *FNMA v. Commissioner*, petitioner asks that plenary review be given by this Court only to the *Centennial* and *First Federal* decisions.

Petitioner argues that this Court should not give plenary review to *San Antonio* because of "uncertainty" over whether that thrift's entry into receivership in July 1989, and the fact that San Antonio has not yet paid the tax deficiency, renders the exchange issue "moot" in that case. He argues that a collectibility issue does not exist in *Centennial* because that taxpayer paid its tax and then sued for refund in the U.S. District Court. Petitioner asks for plenary review in both *Centennial* and *First Federal* presumably in order to place before this Court one case involving an insolvent savings and loan association and one involving a solvent savings and loan, respectively. This is a distinction without a difference. The substantive tax issues involved in deciding whether losses are deductible from exchanges of loan portfolios are not affected by a taxpayer's solvency. There is no substantive reason for this Court to give plenary review to the deduction issue because a thrift is insolvent or in receivership.

The U.S. League believes that the Court should select those one or more cases most representative of the taxpayers affected by the issue and its ramifications, and which will give the Court the opportunity to hear the fullest adversary presentation of arguments on both sides of the issue. It should be noted that in the *Centennial* and *San Antonio* cases, where the taxpayer is in receivership, a governmental agency is represented on both sides of the issue.

For reasons stated below, we believe that if the Court decides to hear the mortgage exchange issue, it should

grant plenary review to the *First Federal* and *Cottage Savings* decisions. Both cases involve solvent savings and loan associations and private taxpayers having a real financial stake in the wide array of business transactions impacted by the tax collector's position.

The mortgage exchange issue raises fundamental questions of tax common law involving threshold concepts of realization and recognition of gain and loss which this Court has not reconsidered since the early 1920s. The tax issue broadly affects exchanges of secured debt obligations and other like kind assets. The Commissioner and the Sixth Circuit would radically upset the long-settled tax concepts of *realizing* and *recognizing* loss from a sale or exchange of property and the meaning of *sustaining* a loss under Section 165 of the tax code. If the Commissioner's argument in these cases and the Sixth Circuit's holding in *Cottage Savings* on Section 165 are accepted by this Court, the adverse impact on the healthy portion of the thrift industry and on business transactions generally would be far-reaching. The relation between the "sustained" provision of Section 165 and the realization and recognition requirements of Section 1001 has serious implications for (1) all taxpayers deducting business losses of all kinds (must any seller be "poorer" after the sale?); (2) commonplace year-end sales of stocks and bonds designed to realize investment losses offsetting gains during the same year; and (3) distinguishing "tax shelters" where losses are "manufactured" rather than produced by bona fide declines in market value. Petitioner's own position that income or loss is not realized if a taxpayer buys similar property has vast *revenue-losing* potential for the Government since solvent sellers of all

types of property can use the Commissioner's own arguments to contend for nonrealization of *business gains*.

The important consideration, we submit, is to select for plenary review the case or cases involving taxpayers who actually or potentially have a financial stake in all of these ramifications of the Government's, and of the Sixth Circuit's, position on mortgage exchanges. Hearing arguments from such a taxpayer – opposed by the governmental interest represented by the Solicitor General on behalf of the Internal Revenue Service – is, we believe, the best way to focus all pertinent aspects of this tax issue for the Court's benefit. *Cf. Baker v. Carr*, 369 U.S. 186, 204 (1962) ("concrete adverseness . . . sharpens the presentation of issues upon which the court so largely depends for illumination of difficult constitutional questions"). Certainly, full adversarial status can be achieved here by full review of the case or cases in which wholly private counsel opposes the governmental interest represented by the Solicitor General.

The cases best presenting the appropriate adversarial interests on the mortgage exchange issue are *First Federal* and *Cottage Savings*.[10]

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[10] The Court, we believe, can accept our recommendation on the mortgage exchange issue while hearing *Centennial* solely on the separate issue of penalty income from early withdrawal of time deposit accounts (if the Court otherwise decides to review that subject).

If this Court should be inclined to grant plenary review to the *FNMA* case, the Court should be aware that FNMA is not a regulated savings and loan institution and was not subject to Regulatory Memorandum R-49. If the Court chooses to give plenary review solely to *FNMA*, the Court should satisfy itself that it can still consider the sub-issue of the effect, if any, of regulatory accounting rules on the deductibility of a loss under § 165 and/or on the criteria for realization of loss under § 1001.

CONCLUSION

Regarding the mortgage exchange issue, the Question Presented should be revised as stated in this brief rather than as stated by petitioner.

If this Court grants certiorari on the mortgage exchange issue arising in the Fifth, Sixth and District of Columbia Circuits, plenary review should be granted in the *First Federal* and *Cottage Savings* cases or, alternatively, in all of the cases raising the issue from the three appeals courts.

Respectfully submitted,

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July 6, 1990

JOINT

APPENDIX

Supreme Court, U.S.
FILED
NOV 15 1990
JOSEPH F. SPANIOL, JR.
CLERK

(5)

No. 89-1926

In the Supreme Court of the United States

OCTOBER TERM, 1990

UNITED STATES OF AMERICA, PETITIONER

v.

CENTENNIAL SAVINGS BANK, FSB
(RESOLUTION TRUST CORPORATION, RECEIVER)

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

JOINT APPENDIX

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PETITION FOR WRIT OF CERTIORARI
FILED JUNE 8, 1990
CERTIORARI GRANTED OCTOBER 1, 1990

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JOINT APPENDIX

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* The opinion of the court of appeals, the order of the court of appeals denying rehearing, and the opinion of the district court are printed in the appendix to the petition for writ of certiorari and have not been reproduced here.

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UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

No. CA3-86-1396-H

CENTENNIAL SAVINGS BANK FSB, PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

DOCKET ENTRIES

Date	NR	Page	Proceedings
1986			VOL. I.
May 23	1	1	COMPLAINT. (7+)
	2		ISSUED SUMMONS. (3)
July 22	3	175	*ANSWER* OF UNITED STATES OF AMERICA TO ORIGINAL COMPLAINT (4)
Aug 28	4	179	ORDER counsel to file w/in 14 days of this ord. Status Report. copies mailed to counselHBS/dh
Sept 11	5	181	STATUS REPORT (Joint) (4)
Sept 16	6	185	ORDER setting schedule for case . . . NON Jury Trial week of 6/22/87 . . . disc. be completed by 5/4/87 . . . Mots. to join parties due 2/9/87 . . . Mots. to amend pleadings due 3/23/87 . . . Ptrial Ord. due 6/8/87 . . . local rule 8.1(a)(b) be completed by 6/15/87. copies mailed to counselHBS/dh

Date	NR	Page	Proceedings
1987			
Jan 8	7	187	UNOPPOSED MOT TO EXTEND THE TIME TO ANSWER INTERROGATORIES & PRODUCE DOCUMENTS & BRIEF IN SUPPORT THEREOF (3)(pltf.). tn
Jan 9	8	190	ORDER that the time for pltfs. to respond to defts. interrogs & produce docs is extended to 2/27/87. copies mailed to counsel HBS/dh
Apr 2	8A	190A	JOINT MOT/FOR LEAVE TO DESIGNATE EXPERT WITNESSES. (2)
Apr 3	9	191	ORDER that the parties are granted leave to designate expert witnesses no later than 30 days before trial and further orders that the time for deposing expert witnesses be extended to the 20 day before trial. HBS/dh copies mailed to counsel
Apr 22	10	192	NOTICE TO TAKE ORAL DEPOSITION of Robert J. Mahn, FNMA, Washington, D.C. 5/6/87 1:00 p.m. trw
	11	195	NOTICE TO TAKE ORAL DEPOSITION of Federal National Mortgage Association, Washington, D.C., 5/6/87, 9:00 a.m. trw

Date	NR	Page	Proceedings
Apr 23	12	201	U. S. OF A'S. AGREED MOTION TO EXTEND TIME FOR COMPLETION OF DISC. (3) dh
Apr 24	13	204	ORDER that the time for completion of disc. is extended to 5/15/87 . . . that all other dates set by the Court for the preparation & trial of this case shall continue in effect. copies mailed to counsel HBS/dh
May 8	14	205	NOTICE OF ADDITIONAL COUNSEL of Edward S. Koppman and Kathleen J. St. John on behalf of Plaintiff. (2) go
	15	207	PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT. (5) go
	16	212	PLAINTIFF'S MEMORANDUM OF LAW IN SUPPORT OF ITS MOTION FOR SUMMARY JUDGMENT.
May 29	17	234	ORDER that the depo. of expert witnesses shall be completed on or before 6/3/87 . . . all other dates set in the Court's prior scheduling ord. shall remain in effect. copies mailed to counsel HBS/dh
May 20	18	235	DESIGNATION OF EXPERT WITNESSES (USA) (2) trw

Date	NR	Page	Proceedings
May 22	19	237	DESIGNATION OF EXPERT WITNESSES (Centennial Savings Bank FSB) (2) trw
			VOL. II
May 28	20	239	UNITED STATES OF AMERICA'S MEMORANDUM OF LAW IN OPPOSITION TO PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT (15+) trw
	21	261	AFFIDAVIT OF GROVER HARTT, III (15+) trw
	22	302	UNITED STATES OF AMERICA'S APPENDIX OF AUTHORITIES (15+) trw
Jun 5	23	389	ORDER . . . That the time for filing the pretrial order be extended to 5:00pm, 6/9/87. That all other dates set in the court's prior scheduling order shall remain in effect. Cys to cnsl . . . . Dckted 6-8-87 BS/trw
	24	390	CENTENNIAL SAVINGS BANK FSB'S AGREED MOTION TO EXTEND TIME FOR FILING PRETRIAL ORDER (2) trw
Jun 10	25	392	ORDER that the 6/22/87 trial setting is VACATED & reset for trial for the week of 9/28/87 . . . ptrial ord. due 6/15/87 . . . Local Rule 8.1(a)(b) shall be

Date	NR	Page	Proceedings
			completed, & objections to exhibits & objections to depo. designations shall be filed by 6/29/87 . . . briefing schedule; briefs to be filed by noon on dates shown: 8/3/87-Pltfs. initial brief; 8/10/87-Defts. brief; 8/24/87-Pltfs. reply brief; 8/31/87-Defts. reply brief. copies mailed to counsel HBS/dh
Jun 8	26	393	UNITED STATES OF AMERICA'S MOTION IN LIMINE (6) trw
	27	399	BRIEF IN SUPPORT OF UNITED STATES OF AMERICA'S MOTION IN LIMINE (4) trw
Jun 9	28	403	MOTION FOR LEAVE TO FILE A SUPPLEMENTAL DESIGNATION OF EXPERT WITNESSES (2) trw
May 29	29	405	UNITED STATES OF AMERICA'S AGREED MOTION TO EXTEND TIME FOR DEPOSITIONS OF EXPERT WITNESSES (2) trw
	30	408	NOTICE TO TAKE ORAL DEPOSITIONS of Don Zellmer, 6/1/87 1:00 p.m.; Chester Spratt 6/3/87 10:00 a.m., Dallas, Texas (3) trw

Date	NR	Page	Proceedings
Jun 10	31	411	UNITED STATES OF AMERICA'S RESPONSE TO PLAINTIFF'S MOTION TO SUPPLEMENT ITS DESIGNATION OF EXPERT WITNESSES (4) trw
Jun 15	32	415	ORDER that Centennial Savings Bank be granted leave to file a Supplemental Designation of EXpert Witnesses designating Charles Senning & Christine Henley as experts, who must be made available for depo on or before 8/3/87. copies mailed to counsel HBS/dh
June 15	33	416	PRETRIAL ORDER . . . est. length of trial, Non jury trial 2 to 3 days. HBS/dh
Jun 15	34	432	UNITED STATES OF AMERICA'S PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW (15+) trw
	35	454	UNITED STATES OF AMERICA'S LIST OF WITNESSES (5) trw
	36	459	PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW OF CENTENNIAL SAVINGS BANK FSB (5) trw
	37	465	LIST OF WITNESSES WHO MAY BE CALLED AT TRIAL BY CENTENNIAL SAVINGS BANK, (6) trw

Date	NR	Page	Proceedings
Jun 25	38	472	AGREED MOTION FOR EXTENSION TIME to comply with Local Rule 8.19a)(b). (3)
Jun 26	39	475	ORDER that the time w/in which actions required by Local Rule 8.1(a)(b) be completed, & objections to exhibits & objections to depo. designations shall be filed, shall be & is hereby extended to & including 7/10/87. copies mailed to counsel HBS/dh
Jun 29	40	476	RESPONSE OF CENTENNIAL SAVINGS BANK FSB TO U.S.A MTION IN LIMINE
Jun 30	41	485	MEMORANDUM OPINION AND ORDER that Pltfs. Motion for Summary Judgment, filed 5/8/87 is DENIED. copies to counsel dkt'd 6/30/87 (3) HBS/dh
Jul 2	42	488	UNITED STATES OF AMERICA'S REPLY TO CENTENNIAL SAVINGS BANK FSB REGARDING EXPERT WITNESSES (11) trw
			VOL. III
Jul 6	43	499	PLTF'S REPLY MEMORANDUM OF LAW IN SUPPORT OF ITS MOTION FOR SUMMARY JUDGMENT (15+) trw
	43A	"A"	Received Pltf's Reply Memorandum of Law in Support of its

Date	NR	Page	Proceedings
			Motion for Summary Judgment (15+) trw
Jul 7	44	535	SUPPLEMENTAL DESIGNAITON OF EXPERT WITNESSES . . . (2), pltff. pc
Jul 8	45	537	U.S. OF AMERICA'S SUPPLEMENTAL REPLY TO CENTENNIAL'S RESPONSE TO ITS MOTION IN LIMINE . . . (5).
Jul 10	46	541	U.S. OF AMERICA'S OBJECTIONS TO CENTENNIAL'S EXHIBITS . . . (5) pc
Jul 10	47	545	CENTENNIAL SAVINGS BANK FSB.'S EXHIBIT LIST . . . (5).
Jul 10	48	550	CENTENNIAL SAVINGS BANK FSB.'S DESIGNATION OF DEPOSITIONS . . . (3).
Jul 10	49	552	OBJECTIONS TO PLTFF TO PROPOSED EXHIBITS OF DEFT . . . (5).
Jul 10	50	557	U.S. OF AMERICA'S EXHIBIT LIST . . . (5).
Jul 14	51	564	PLTFS. MOTION FOR RECONSIDERATION of denial of Summary Judgment. (3)
Jul 15	52	567	ORDER deft. is to file any response to next above motion by 7/24/87 copies mailed to counsel HBS

Date	NR	Page	Proceedings
Jul 20	53	568	CENTENNIAL SAVINGS BANK FSB'S MOTION FOR LEAVE TO FILE A SUPPLEMENTAL DESIGNATION OF EXPERT WITNESSES (4) trw
	54	572	AGREED MOTION FOR EXTENSION OF TIME TO DEPOSE CHRISTINE HENLEY (2) trw
Jul 21	55	574	AGREED STIPULATION (1) (Pltf) trw
	56	575	UNITED STATES OF AMERICA'S RESPONSE TO CENTENNIAL'S MOTION TO RECONSIDER DENIAL OF ITS MOTION FOR SUMMARY JUDGMENT (11) trw
	57	586	RESPONSE OF THE UNITED STATES TO CENTENNIAL'S SECOND SUPPLEMENTAL INTERROGATORY RESPONSES AND MOTION FOR LEAVE TO FILE A SUPPLEMENTAL DESIGNATION OF EXPERT WITNESSES (12) trw
Jul 27	58	598	ORDER that the time for tendering Christine Henley for depo. be extended to 8/31/87. copies mailed to counsel HBS/dh
Jul 24	59	599	APPLICATION OF CENTENNIAL SAVINGS BANK FSB

Date	NR	Page	Proceedings
			TO FILE A REPLY TO RESPONE OF THE UNITED STATES TO CENTENNIAL'S SECOND SUPPLEMENTAL INTERROGATORY RESPONSES AND MOTION FOR LEAVE TO FILE A SUPPLEMENTAL DESIGNATION OF EXPERT WITNESSES (2) trw
Aug 4	60	601	ORDER . . . Pltf's motion for reconsideration filed 7/14/87 is denied. Cys to cnsl . . . Dckted 8-4-87 HBS/trw
	61	602	CENTENNIAL'S ORIGINAL BRIEF (15+) trw
	61A	666	Received PLTF'S ORIGINAL BRIEF (15+) Selected Authorities trw
			VOL. IV.
Aug 10	62	771	UNITED STATES OF AMERICA'S TRIAL BRIEF (15+ under separate cover) trw
Aug 24	63	980	UNITED STATES OF AMERICA AGREED MOTION TO ENLARGE TIME FOR CHRISTINE HENLEY DEPOSITION (3) trw
			VOL. V
	64	983	CENTENNIAL'S REPLY BRIEF trw
	64A	1031	(Selected Authorities)

Date	NR	Page	Proceedings
Aug 25	65	1079	ORDER that the 8/24/87 Agreed Motion is GRANTED, & the Henley depo. may be taken 9/2/87 or such otehr time as may be mutually agreed upon. copies mailed to counsel HBS/dh
Mar 2	82	1080	JUDGMENT that Pltf. take nothing from the deft . . . that Centennial shall have & recover from the US the sum of $59,544.00 in taxes & $41,027.00 in assessed interest for a total of $100,571.00 on its claim for refund arising out of its tratement of premature w/drawal penalties on ist certificates of deposit as income from the discharge of indebtedness; . . . that the aforesaid sum of $100,571.00 to be refunded to Centennial shall accrrue additional int. according to law from 11/14/85 & until such amount is paid to Centennial pursuant to this Judgment; . . . that all relief sought & not granted or denied is denied . . . that each partty shall bear its own respective costs of court. dkt'd 3/2/88 HBS/dh copies mailed to counsel
Aug 31	66	1082	UNITED STATES OF AMERICA'S REPLY BRIEF (15+) trw

Date	NR	Page	Proceedings
Sept 21	67	1151	ENTRY OF APPEARANCE (2) USA trw
Sept 25	68	1153	STIPULATION REGARDING OBJECTIONS OF CENTENNIAL SAVINGS BANK FSB AND UNITED STATES OF AMERICA TO EXHIBITS (4)
	69	1157	UNITED STATES OF AMERICA'S SUPPLEMENTAL APPENDIX OF AUTHORITIES IN I REPLY BRIEF (14)
Sept 28	70	1171	AGREED SUPPLEMENTAL STIPULATION (3)
	71	1174	CENTENNIAL SAVINGS BANK FSB'S MOTION FOR LEAVE TO REVISE AND SUPPLEMENT EXHIBIT LIST (7)
	72	1181	CENTENNIAL'S MOTION FOR LEAVE TO SUPPLEMENT OBJECTIONS OF PLTF TO PROPOSED EXHIBITS OF DEFT (5)
Sep 29	73		MIN ENTRY . . . Trial to Court 1st Day . . . witnesses sworn . . . exhibits admitted . . . cont. to 9/30/87, 9AM HBS/dh
Sep 30	74		MIN ENTRY . . . Trial to court 2 day . . . cont. to 10/1/87 HBS/dh
Oct 1	75		MIN ENTRY . . . Trial Court 3rd day . . . cont. to 10/2/87 9 AM HBS/dh

Date	NR	Page	Proceedings
Oct 2	76		MIN ENTRY . . . Trial to Court 4th day . . . cont. to 10/9/87 for Judgment. HBS/dh
Oct 14	77		TRANSCRIPT OF PROCEEDINGS TESTIMONY OF SPATT AND ZELLMER HELD BEFORE THE HONORABLE BAREFOOT SANDERS on 9-29-87. (15+) (UNDER SEPARATE COVER) kds
Oct 13	78	1186	Letter of John P. Buser to Judge Sanders regarding discussion of a new section of Internal Revenue Code of 1986, etc. ((15+) kds
Oct 15	79	1208	Letter of Louise P. Hytken to Judge Sanders replying to the remarks of Centenniel's letter of October 13, 1987. (4) kds
Nov 27	80		PARTIAL TRANSCRIPT OF PROCEEDINGS BEFORE THE HONORABLE BAREFOOT SANDERS (Under separate cover) trw
1988			
Jan 22	81	1212	MEMORANDUM OPINION AND ORDER . . . the Court holds that becuase the mortgage loans in the R-49 transaction were not materially different in kind or extent, thus leaving

Date	NR	Page	Proceedings
			Centennial in the same economic position before and after the exchange, Centennial is not entitled to claim a tax loss from the R-49 transaction . . . the Court also holds that in 1981 Centennial was entitled to treat its income from the premature w/drawal penalty on its certificates of deposit as income from the discharge of indebtedness . . . the govt. will promptly submit a judgment prepared in accordance with this opinion. dkt'd 1/22/88 HBS/dh copies mailed to counsel
Apr 22	83	"B"	TRANSCRIPT OF PROCEEDINGS TRIAL ON ITS MERITS BEFORE THE HONORABLE BAREFOOT SANDERS (VOLUME I) (15+) (under separate cover) ns
	84	"B"	TRANSCRIPT OF PROCEEDINGS TRIAL ON ITS MERITS BEFORE THE HONORABLE BAREFOOT SANDERS (VOLUME II) (15+) (under separate cover) ns
Apr 28	85	1249	PLTF'S NOTICE OF APPEAL (1) from those portions of final judgment entered 3-2-88, which deny Pltf's recovery of tax refund on its claim rising out of its

Date	NR	Page	Proceedings
			R-49 reciprocal mortgage sales transactions w/Federal National Mortgage Association and its respective court costs and (2) from Order entered 6-30-87 denying Pltf's Mtn for Summary Judgment on ground that government assessed deficiencies at issue after statute of limitations for assessment had run. (2) TO to atty at counter; #39586 $105.00 appeal fee paid ns
May 2			Mld certified copy of Notice and Docket Entries to USCA5; cy. Notice to Kendrick, Buser, Balestri, Koppman, and St. John; and Hartt and Hytken; Cy Notice to Ct. Reporter Carl Black; CTCRD ns
May 2	86	1251	DEFT'S NOTICE OF APPEAL from that portion of Judgment filed 3-2-88, which grants pltf refund of taxes arising out of its treatment of premature withdrawal penalties on its certificates of deposit as income from the discharge of indebtness (2) TO to atty at counter; no fee, USA ns
May 3			Mld certified copy of Notice and Docket Entries to USCA5; cy. Notice to Koppman, Buser, Balestri, St. John & Kendrick;

Date	NR	Page	Proceedings
			and Hartt, Hytken Thurmond; cy. Notice to Ct. Reporter CArl Black and Ctroom Deputy. ns
	87		TRANSCRIPT ORDER . . . by appellant U.S.A., ordering proceedings of 9-29-87 through 10-2-87 and closing arguments on 10-9-87. go
May 5	88		TRANSCRIPT ORDER . . . by appellant Centennial Savings Bank FSB . . . ordering proceedings of 9-29-87 thru 10-2-87 (entire transcript); and 10-9-87 (closing argument). go
Jun 6		"C"	TRANSCRIPT OF PROCEEDINGS . . . "TRIAL ON ITS MERITS" . . . held September 29, 1987 before Judge Barefoot Sanders. (Volume III) go
Jun 9			Received Trial Exhibits from Court:
		"B"-1	PX-1 thru 15, 21 thru 33, 36, 40 thru 43, 48 thru 50, 54 thru 58, 68 and 69;
		"B"-2	DX-6 thru 8, 10, 14 thru 18, 20, 21, 23 thru 30, 32 thru 39, 41 thru 57, 62, 64 thru 67. go
Jun 9			Transmitted Original record to USCA5 via UPS:
			case papers—6 Volumes, (1 of the Vol. labeled "A");

Date	NR	Page	Proceedings
			transcripts—3 Volumes, labeled "B" & "C";
			exhibits—Pltf's Exhibits (1 Folder; 1 Notebook);
			Deft's Exhibits (2 Notebooks; 1 Envelope), labeled "B"-1 and "B"-. go

UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

No. 88-1297

CENTENNIAL SAVINGS BANK FSB, PLAINTIFF-APPELLANT,
CROSS-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLEE,
CROSS-APPELLANT

APPEALS FROM THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS

DOCKET ENTRIES

APPEARANCE FILED-DATE	CODE	ATTORNEYS FOR APPELLANT	ARG
		AKIN, GUMP, STRAUSS, HAUER & FELD, 4100 First City	
5-12-88	X	Kathleen J. St. John, -do- Center, 1700 Pacific	
5-12-88	"	Edward S. Koppman, -do- Ave., Dallas, TX 75201-	✓
		(214/969-2800) 4618	
		(For Amicus Curiae - U.S. League of Savings Institutions)	
8-10-88	"	Richard L. Bacon, Spec. Tax Counsel, U.S. Leage of Savings	
		Institutions, Ste. 700, 1201 Pennsylvania Ave., N.W.,	
		Wash. D.C. 20004 (202)637-2050	
8-22-88		Thomas A. Pfeiler, Gen. Counsel, III E. Wacker Dr., Chicago, IL	
		25th Floor, (312)644-3100	60601

APPEARANCE FILED-DATE	CODE	ATTORNEYS FOR APPELLEE	ARG
		~~Grover Hartt, III, D of J, Tax Div., Rm. 5B31, 1100 Commerce, Dallas, TX 75242-0599 (214/767-0293)~~	
5-23-88	"	Gary R. Allen, Chief, Appellate Section, Tax Div., Dept. of	
5-23-88	X	William S. Rose, Jr. AAG, Justice, P. O. Box 502, Washington	
11-25-88	X	Richard Farber, -do- D.C. 20044 (202) 633-3361	
11-25-88	X	Bruce R. Ellisen, -do-	✓

CLOSED

18

TITLE: CENTENNIAL SAVINGS BANK vs. U.S.A. NO. 88-1297

1. RECORD, EXHIBITS AND BRIEF INFORMATION

Filing:	
	Reporter's Ack. due _____ Trans. Fld. _____
	Transcript due 6/6 Disc. Date 7/5
	Partial Record or Cert. List
6-14-88	Record on Appeal No. of Vols. 9
	Supp. Record No. of Vols.
	Second Supp. Record No. of Vols.
	Third Supp. Record No. of Vols.
6-14-88	Exhibits ☐ Env. ☒ Box ☐ Pkg. ☐ Roll
	Exhibits ☐ Env. ☐ Box ☐ Pkg. ☐ Roll
	Appendix ☐ (P) ☐ (M)
SEP - 1 1988	Records Excerpts – Appellant
	Record Excerpts – Appellee
	Briefing Notice Issd. 2-1-
SEP - 1 1988	Brief for Appellant
	Brief for Appellant
NOV 25 1988	Brief for Appellant
	Brief for Cr. Appellant
	Brief for Appellee
	Brief for Appellee
FEB 16 1989	Brief for Cr. Appellee
	Reply Brief for Appellant
	Reply Brief for Cr. Appellant
	Supp. Brief for Appellant
	Supp. Brief for Appellee
SEP 15 1988	Brief for Amicus Liberty for Immigration
	Intervenor
5-1-89	Rule 28(j) letter–Appellant (5)
	Rule 28(j) letter–Appellee
2-21-89	BRIEF for Amicus Curiae Centennial SAVINGS BANK FSB

4. EXTENSION Flg. Motion for:

	Order Fld.	Ext. to:
_____ Transcript		
_____ Transcript		
_____ Transcript		
6/24/88 Appellant's Brief		8/26/88
_____ Appellant's Brief		
_____ Appellant's Brief		
10/17/88 Appellee's Brief		11/2/88
11/14/88 Appellee's Brief		11/23/88
_____ Appellee's Brief		
_____ Reply Brief		

5. CALENDAR INFORMATION Week of 5-1-89

Special Panel _____

Summary Panel: _____

3-24-89 Case Assigned for 5-2-89 in ☒ EB ☐ W ☐ E ☐ _____

_____ Case Cont'd for Reassignment _____

_____ Case Reassigned for _____ in ☐ EB ☐ W ☐ E ☐ _____

Hearing Panel: JRB-JSW-Jolly

5-2-89 Case Argued ☒ by Appellant ☒ by Appellee

_____ Case Sub. w/o Arg. ☐ by Appellant ☐ by Appellee

6. OPINION INFORMATION P ☒ NP ☐ _____ Print Pages

11/02/89 Opinion Rendered

	Affirmed				
	Reversed				
JSW	Affd. in Pt.		P.C.		Conc. Spec.
	Vacated	XXX	Signed		Dis.
	Dismissed		Rule 47.6		Dis. in Pt.

_____ Opinion Withdrawn _____

MISCELLANEOUS FILINGS

Filing:	
5/5/88 (C) 5/6/88 (USA)	Dup. Notice of Appeal and Clerk's Statement of Docket Entries
	Papers Trans. from Misc. No. _____
	Order of DC Granting/Denying Appeal IFP
	Order of DC Granting/Denying IFP & CPC
	Order of DC Appointing Counsel
	Affidavit of Financial Status
	CJA 20 Issd./Voucher Recd. _____
	NOA Treated as CPC Application

AGENCY REVIEW CASES

Filing:	
	Petition for Review of Order ( ) of ☐ NLRB ☐ FERC ☐ ICC ☐
	Application for Enforcement–NLRB
	Answer to Application for Enforcement
	Cross Application for Enforcement

7. REHEARING INFORMATION

11/15/89	Mot. for Ext.–Ext. to: 12/16/89 (Monday)
	Mot. for Ext.–Ext. to: _____
12-15-89	Petition for Rehearing (5) ☐ Appellant ☒ Appellee ☒ Reg. ☐ En Banc
12-15-89	Petition for Rehearing (5) ☐ Appellant ☒ Appellee ☐ Reg. ☒ En Banc
	Response of _____
JAN 19 1990	Order Denying Rehearing (JJ)
	☐ Dissenting
	☐ Opinion on Petition for Rehearing

NO. 88-1297

8. MOTIONS

Filing Motion to or for:	Response Filed By	Date	Granted	Denied	By Court	By Clerk	Date
Mandamus							
Reinstate Appeal							
Stay Further Proceedings in CA							
Stay Pending Appeal							
Injunction Pending Appeal							
Consolidate Appeals W/							
Leave to Appeal IFP							
Bail Pending Appeal							
Withdraws as Counsel							
Appointment of Counsel							
Supplement Record							
Expedite							
8/19/88 File Brief in Excess Pgs. (60) Appellant		8-19-88; EGJ					
11/16/88 File Brief in Excess Pgs. (75) Appellee			✓		EGJ	SJ	8/24/88 11/15/88
Dismiss by Appellant							
Dismiss by Appellee							
7/21/88 Amicus Curiae (U.S. League of Savings)			✓			✓	7/29/88
File Supp. Brief							
Stay of Mandate							
Recall of Mandate							
Intervene							
Intervene							
File Reply Br. out of time							

9. OTHER DOCKET ENTRIES

8/24/88	Flg. Order granting mot. of appellant for leave to file brief in excess of 50 pages, but not to exceed 60 pages - although the Court has the impression that it can be done in 50 pages and every effort should be made to trim it. (EGJ)
9/8/88	Flg. Mot. of appellant to correct brief. (Unopposed Mot. Granted - SV - 9/8/88)
10/3/88	Flg. Mot. of U.S. League of Savings Institutions for leave to file brief as amicus curiae in support of Centennial Savings Bank's cross appellee's brief, on the penalty income issue.
10/7/88	Flg. Ltr. of atty. for appellee in case No. 88-1723 dtd. 10/6/88 requesting that case 88-1723 and this case and 88-4717 be calendared back-to-back for oral argument. (SEND TO SCT. JUDGE AND PANEL) (Also fld. in 88-1723 and 88-4717)
10/14/88	Minute Entry - Unopposed Mot. of U.S. League of Savings to file amicus brief in support of Centennial Savings Bank's cross appellee's brief on penalty income issue has been granted -SV- 10/14/88)

10. JUDGMENT OR MANDATE INFORMATION

NOV 2 1989	Bill of Costs
	Flg. & Entg. Judgment
	Issg. Copy of Jdgt. to Bd & Cnsl.
1-29-90	Mandate Stayed to
	Jdgt. as Mdt. Issd. to Clerk
	Jdgt. as Mdt. Reissd. to Clerk
1-29-90	Dismissal Issd. to Clerk
1-29-90	Record on Appeal Retd. to Clerk 9 vols.
1-29-90	Exhibits Retd. to Clerk 1 Box

11. SUPREME COURT INFORMATION

	Notice of Appeal to S.C.
	Preparing Proceedings on Certiorari
	Preparing Supp. Proceedings on Cert.
4/12/90	Transmitting Orig. Exhibits to S.C.
	Order of S.C.—Ext. to 5/12/90
10/5/90	Notice of Flg. of Cert. Pet. on
	Order of S.C. ☐ Denied ☑ Granted 10/1/90
	Notice of Denial of Pet. for Rehearing
	Opinion of S.C. dated
	S.C. Docket # 89-1924
	S.C. Subj. Matter ☐ Crim ☐ USC ☐ P. Civ. ☐ AGCT
5/7/90	Order of S.C. extd. to 6/12/90

FIRST FEDERAL SAV. & LOAN OF TEMPLE vs. USA

88-1297

Date	Filings-Proceedings
10/21/88	Flg. Unopposed motion to set agreed briefing schedule. (APPROVED 10/21/8 REW.) Also filed in 88-1723 & 88-4717.
2/16/89	Flg. Mot. of cross appellee for leave to file brief in excess pages but not to exceed 52. (Granted - SV - 2/16/89)
1/14/89	Flg. Mot. of appellant for clarification of the Court's opinion rendered on 11/2/89.
11/22/89	Flg. Order granting mot. of appellant for clarification of the Court's opinion rendered 11/2/89. The cause is remanded for determination of the amount owed Centennial Savings Bank subject to further notification by the parties that the amount is not in controversy. (JRB/JSW/EGJ)

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

Civil Action No. CA-3-86-1396-H

CENTENNIAL SAVINGS BANK FSB, PLAINTIFF

vs.

UNITED STATES OF AMERICA, DEFENDANT

[Filed Mar. 2, 1988]

JUDGMENT

Pursuant to this Court's Memorandum Opinion and Order entered on January 22, 1988, it is hereby

ORDERED, ADJUDGED and DECREED–

(1) that plaintiff, Centennial Savings Bank FSB, shall take nothing from the defendant, United States of America, on its claim for refund arising out of its R-49 transaction with the Federal National Mortgage Association;

(2) that Centennial shall have and recover from the United States the sum of $59,544.00 in taxes and $41,027.00 in assessed interest for a total of $100,571.00 on its claim for refund arising out of its treatment of premature withdrawal penalties on its certificates of deposit as income from the discharge of indebtedness;

(3) that the aforesaid sum of $100,571.00 to be refunded to Centennial shall accrue additional interest ac-

cording to law from November 14, 1985 and until such amount is paid to Centennial pursuant to this Judgment;

(4) that all relief sought by the parties herein and not hereinabove granted or denied is hereby denied; and

(5) that each party shall bear its own respective costs of court.

/s/ Barefoot Sanders
BAREFOOT SANDERS
Acting Chief Judge
Northern District of Texas

APPROVED AS TO FORM: March 2, 1988

/s/ Edward S. Koppman
EDWARD S. KOPPMAN, P.C.
Akin, Gump, Strauss,
Hauer & Feld
4100 First City Center
1700 Pacific Avenue
Dallas, Texas 75201-4618
214/969-2846

ATTORNEY FOR PLAINTIFF

/s/ Grover Hartt, III
GROVER HARTT, III
WALTER B. THURMOND
Attorneys, Tax Division
Department of Justice
Room 5B31, 1100 Commerce Street
Dallas, Texas 75242-0599
214/767-0293

ATTORNEY FOR UNITED STATES

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 88-1297
D.C. Docket No. CA3-86-1396-H

CENTENNIAL SAVINGS BANK FSB, PLAINTIFF-APPELLANT
CROSS-APPELLEE

versus

UNITED STATES OF AMERICA, DEFENDANT-APPELLEE
CROSS-APPELLANT

[Filed Nov. 2, 1989]

Appeals from the United States District Court for the
Northern District of Texas

Before BROWN, WILLIAMS, and JOLLY, Circuit Judges.

JUDGMENT

This cause came on to be heard on the record on appeal and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the District Court in this cause is affirmed in part, and reversed and rendered in part, and the cause is remanded to the District Court for further proceedings in accordance with the opinion of this Court.

IT IS FURTHER ORDERED that each party bear its own costs on appeal.

November 2, 1989

ISSUED AS MANDATE: JAN 29, 1990

OP-JDT-11

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 88-1297

CENTENNIAL SAVINGS BANK FSB, PLAINTIFF-APPELLANT
CROSS-APPELLEE

versus

UNITED STATES OF AMERICA, DEFENDANT-APPELLEE
CROSS-APPELLANT

[Filed Nov. 22, 1989]

Appeals from the United States District Court for the Northern District of Texas

---

Before BROWN, WILLIAMS and JOLLY, Circuit Judges.

BY THE COURT:

IT IS ORDERED that the motion of appellant for clarification of the Court's opinion rendered November 2, 1989 is Granted. The cause is remanded for determination of the amount owed Centennial Savings Bank subject to further notification by the parties that the amount is not in controversy.

21021-1 (2/79) 3 Gold
21022-9 (2/79) 3 Green
21023-7 (2/79) 3 Blue

SAF Systems and Forms
(American Savings & Accounting Supply, Inc.)

27

FIRST FEDERAL SAVINGS AND LOAN ASSOCIATION GREENVILLE
GREENVILLE, TEXAS

№ 90085

Sample

1. ACCOUNT SUMMARY SECTION

ACCOUNTHOLDER(S):

Account No. _____

Date of Issuance _____

No Additions Permitted

Renewal Term: None
(See Section 4)

OPENING BALANCE	MINIMUM BALANCE REQUIREMENT	MATURITY DATE	TERM	RATE OF EARNINGS PER ANNUM
	$100,000.00			% NO COMPOUNDING

Earnings Distribution Dates: _____

2. GENERAL SECTION This certifies that the Accountholder holds a savings account with the Opening Balance and for the term expiring on the Maturity Date shown hereon in the above named savings institution.

3. EARNINGS SECTION This account shall receive earnings at the Rate of Earnings as above set forth. Such earnings shall be payable on the Earnings Distribution Dates above set forth, provided the balance in the account is not reduced below the Minimum Balance Requirement. If such balance is reduced below the Minimum Balance Requirement, the Rate of Earnings on the remaining balance shall thereafter be reduced to the rate then paid on regular savings accounts (see also Section 5).

4. NO RENEWAL SECTION Upon maturity, this account will be converted to a regular savings account and receive earnings at the rate then paid on regular savings accounts.

5. PENALTY CLAUSE SECTION Except as otherwise provided herein, in the event of any withdrawal of principal from this account prior to maturity, the Accountholder shall forfeit an amount equal to (1) for accounts with a term of less than 90 days, the amount of earnings that the funds withdrawn would have earned if left on deposit until maturity, or (2) for accounts with a term of 90 days to one year, the greater of 90 days earnings, regardless of the length of time the funds withdrawn have remained in the account, or the amount of all earnings earned on the amount withdrawn. The forfeited amount is based on the nominal (simple interest) rate on the account.

The penalty prescribed herein will not be imposed for withdrawal of principal following the death or adjudication of incompetence of any Accountholder.

Any premature withdrawal which reduces the account balance below the Minimum Balance Requirement, or any change in the term or Rate of Earnings prior to maturity, shall be considered as a withdrawal of the entire account balance and shall be subject to the penalty prescribed herein.

Earnings credited to this account may be withdrawn at any time without penalty.

To the extent necessary to comply with these requirements, deductions shall be made from the amount withdrawn or the remaining account balance.

ESLIC

NOT TRANSFERABLE
EXCEPT ON THE BOOKS OF
THE DEPOSITORY INSTITUTION

FIRST FEDERAL SAVINGS AND LOAN
ASSOCIATION GREENVILLE

BY _____
AUTHORIZED SIGNATURE

3 J MBP CD 1-81 D

PLAINTIFF'S EXHIBIT 26

(Excerpts)

NOT TRANSFERABLE
EXCEPT ON THE BOOKS OF
THE DEPOSITORY INSTITUTION

FIRST FEDERAL
of Greenville
Savings and Loan Association

P. O. DRAWER 1158
GREENVILLE, TEXAS 75401

CERTIFICATE OF DEPOSIT

CERTIFICATE NUMBER ► MC - 5851

1. ACCOUNT SUMMARY SECTION Date of Issuance _____ Account No. _____

ACCOUNTHOLDER(S): Sample

$ _____ Opening Balance

$ _____ Minimum Balance Requirement

26 Weeks — Term

Renewal Term: None (See Section 4)

_____ Maturity Date

Rate of Earnings _____ % Per Annum No Compounding

Earnings Distribution Dates: _____

2. **GENERAL SECTION** This certifies that the Accountholder holds a savings account with the Opening Balance and for the term expiring on the Maturity Date shown hereon in the above named savings institution.

3. **EARNINGS SECTION** This account shall receive earnings at the Rate of Earnings as above set forth. Such earnings shall be payable on the Earnings Distribution Dates above set forth, provided the balance in the account is not reduced below the Minimum Balance Requirement. If such balance is reduced below the Minimum Balance Requirement, the Rate of Earnings on the remaining balance shall thereafter be reduced to the rate then paid on regular savings accounts (see also Section 5).

4. **NO RENEWAL SECTION** Upon maturity, this account will be converted to a regular savings account and receive earnings at the rate then paid on regular savings accounts.

5. **PENALTY CLAUSE SECTION** Except as otherwise provided herein, in the event of any withdrawal of principal from this account prior to the maturity date, the accountholder shall forfeit an amount equal to the greater of (1) the total amount of earnings actually paid or credited on the account, or (2) three months earnings, whether earned or not, on the amount withdrawn at the nominal (simple interest) rate above set forth, regardless of the length of time the funds withdrawn have remained in the account. Any premature withdrawal which reduces the account balance below the Minimum Balance Requirement, or any change in the term or Rate of Earnings prior to maturity, shall be considered as a withdrawal of the entire account balance and shall be subject to the penalty prescribed herein. Earnings credited to this account may be withdrawn at any time without penalty. To the extent necessary to comply with these requirements, reductions shall be made from the amount withdrawn or the remaining account balance.

3M 1-69 — M3

DATE	INTEREST CREDITED	WITHDRAWALS	BALANCE

FIRST FEDERAL SAVINGS
AND LOAN ASSOCIATION
OF GREENVILLE

BY _____
AUTHORIZED SIGNATURE

28

6 month

FIRST FEDERAL of Greenville

Savings and Loan Association

P. O. DRAWER 1158
GREENVILLE, TEXAS 75401

CERTIFICATE OF DEPOSIT

CERTIFICATE NUMBER ► MC - 8560

1. **ACCOUNT SUMMARY SECTION** Date of Issuance _____ Account No. _____

ACCOUNT HOLDER(S): _____

_____

$ _____ Opening Balance

$ _____ Minimum Balance Requirement

_____ Renewal Term (See section 4)

_____ Initial Maturity Date

Rate of Earnings _____ % Per Annum No Compounding

No Additions permitted

Earnings Distribution Dates: Beginning _____ and _____ thereafter, with the last distribution on the final maturity date.

2. **GENERAL SECTION** This certifies that the Accountholder holds a savings account with the Opening Balance and for the initial term expiring on the Initial Maturity Date shown hereon in the above named savings institution.

3. **EARNINGS SECTION** This account shall receive earnings at the Rate of Earnings as above set forth. Such earnings shall be payable on the Earnings Distribution Dates above set forth, provided the balance in the account is not reduced below the Minimum Balance Requirement. If such balance is reduced below the Minimum Balance Requirement, the Rate of Earnings on the remaining balance shall thereafter be reduced to the rate then paid on regular savings accounts (see also Section 5).

4. **AUTOMATIC RENEWAL SECTION** This account shall be automatically renewed for an additional 26 weeks at the close of business on the Initial Maturity Date or on the maturity date of any Renewal Term unless (1) it is withdrawn within the 7 day period referred to in Section 5 hereof, or (2) at least 10 days prior to any maturity date, the association gives written notice to the Accountholder that this account will not be renewed. In such latter event, upon maturity the account will be converted to a regular savings account and receive earnings at the rate then paid on regular savings accounts.

The rate of earnings for any Renewal Term shall be at (1) the maximum rate authorized for 26-week certificate accounts by Bank Board regulations then in effect, or (2) at a lesser rate as fixed by the association, provided that at least 10 days prior to a maturity date the association gives written notice to the Accountholder setting forth the renewal term rate.

5. **PENALTY CLAUSE SECTION** Except as otherwise provided herein, in the event of any withdrawal of principal from this account prior to the initial or renewal period maturity date, the Accountholder shall forfeit an amount equal to the greater of (1) all earnings paid, credited or accrued on the amount withdrawn, or (2) three months earnings, whether earned or not on the amount withdrawn at the nominal (simple interest) rate being paid on the account, regardless of the length of time the funds withdrawn have remained in the account.

The penalty prescribed herein will not be imposed for withdrawal of principal following the death or adjudication of incompetence of any Accountholder.

Any premature withdrawal which reduces the account balance below the Minimum Balance Requirement, or any change in the term or Rate of Earnings prior to maturity, shall be considered as a withdrawal of the entire account balance and shall be subject to the penalty prescribed herein.

Earnings credited to the account during any term may be withdrawn at any time during such term without penalty. If the account is renewed at the same earnings rate, earnings during the preceding term as well as the current term may be withdrawn at any time without penalty during the Renewal Term. If the Renewal Term rate is different, earnings in the account at the commencement of the Renewal Term shall be deemed merged with the principal and only earnings for the Renewal Term may be withdrawn at any time without penalty during such term.

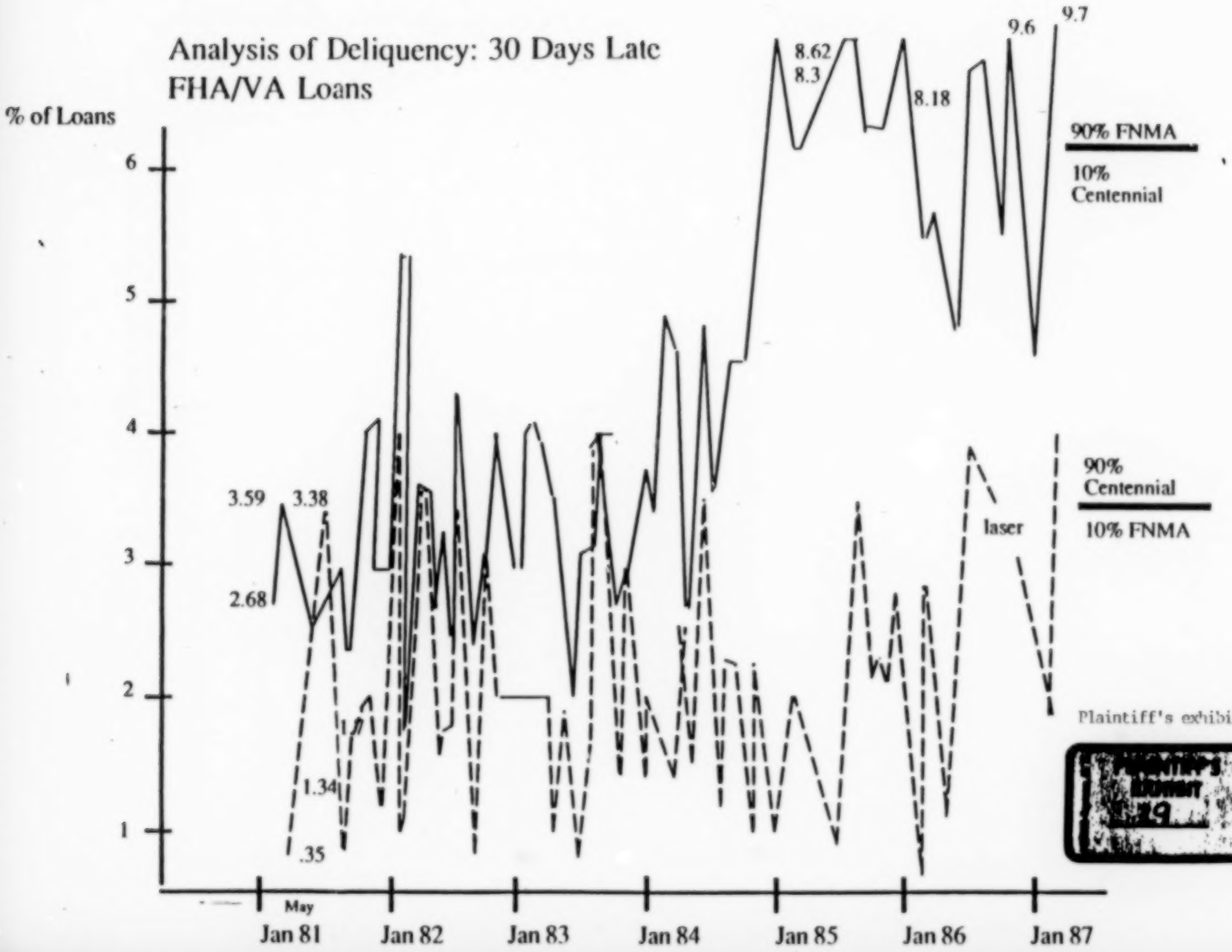
If the account or any portion thereof is withdrawn not more than 7 days after a maturity date, earnings shall be paid thereon at the Rate of Earnings above set forth to the date of withdrawal without penalty.

To the extent necessary to comply with these requirements, reductions shall be made from the amount withdrawn or the remaining account balance.

Not transferable except on the Books of the Depository Institution.

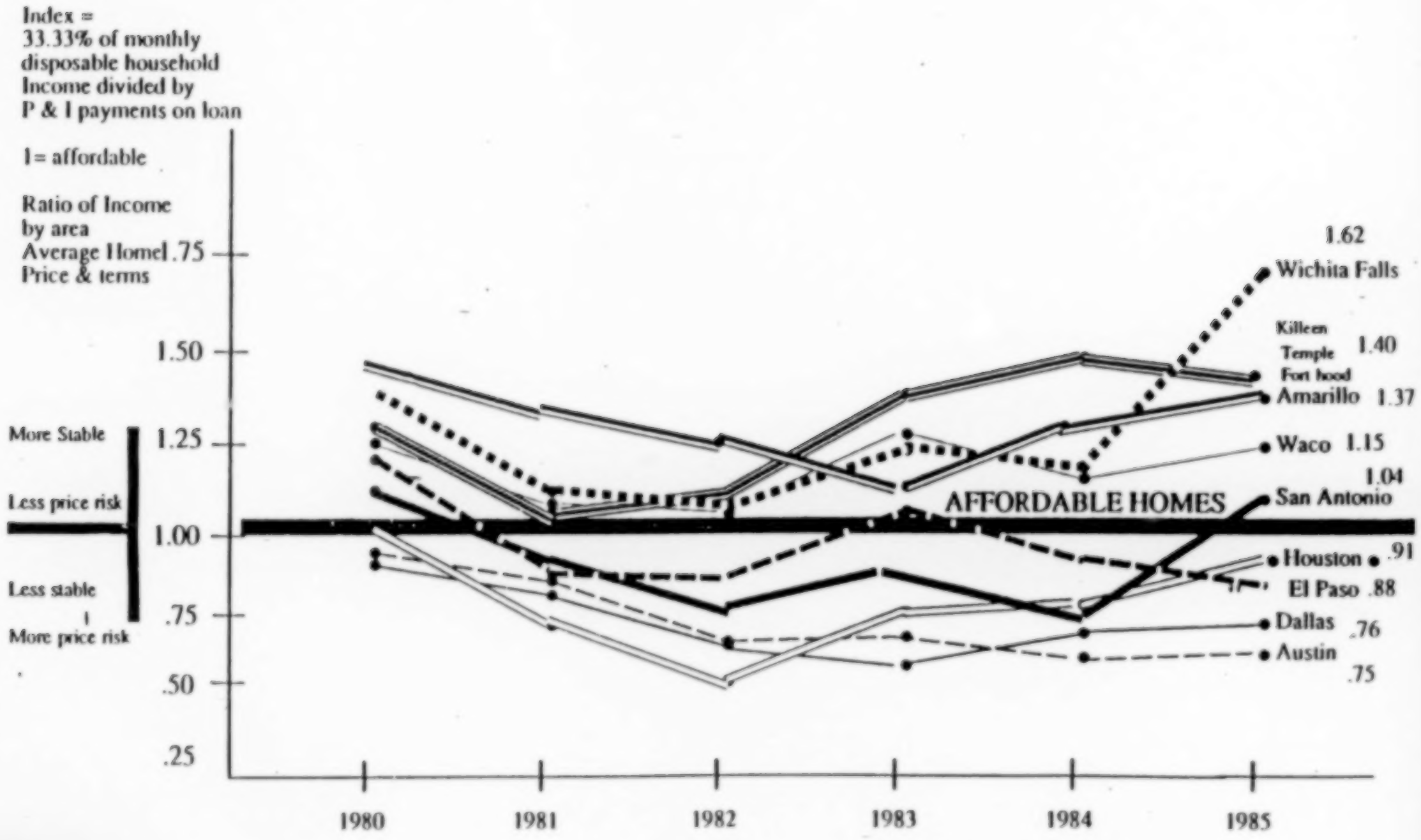
By _____
Authorized Signature

Analysis of Deliquency: 30 Days Late
FHA/VA Loans



Plaintiff's exhibit 29

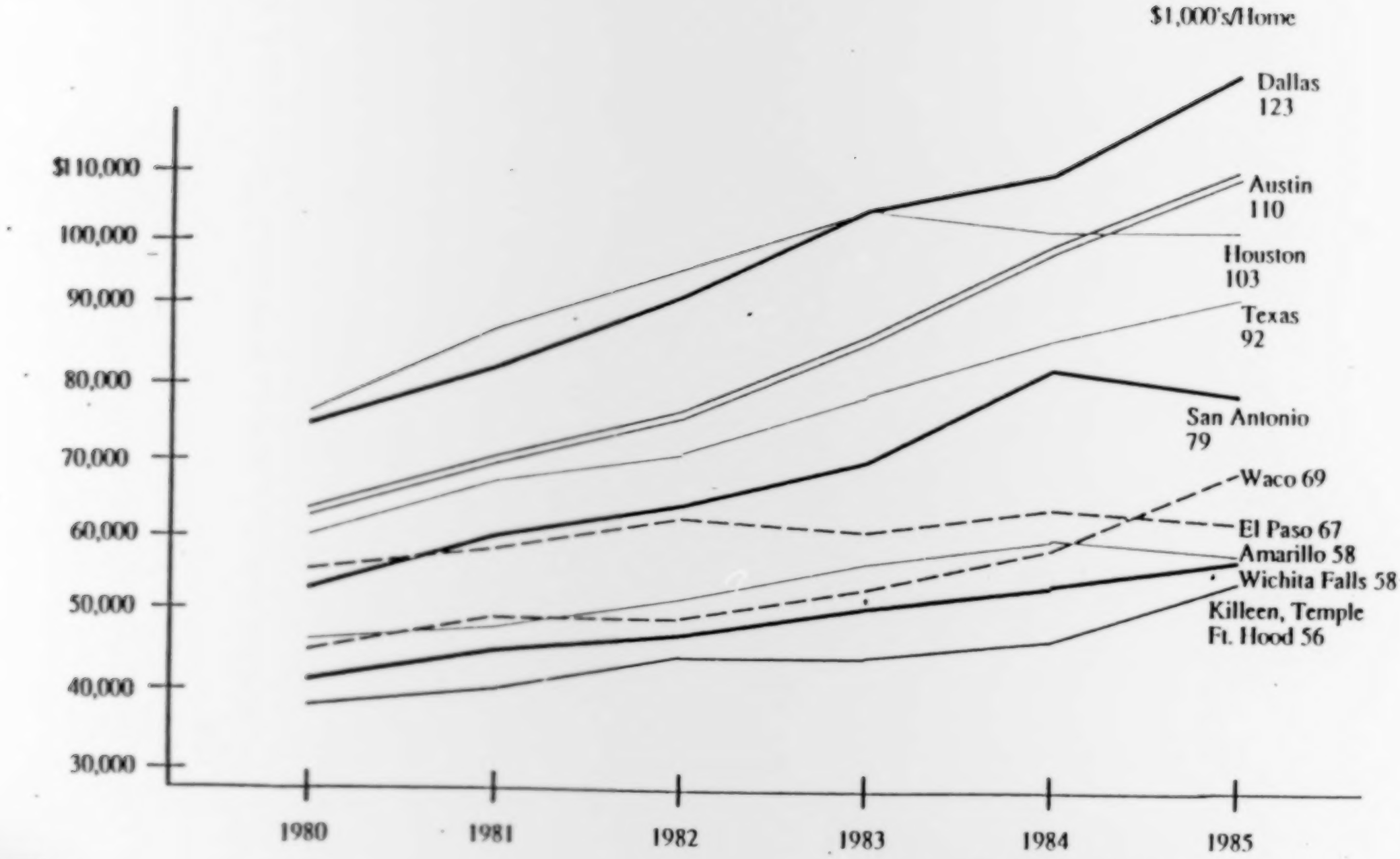
TREC's Texas Housing Affordability Index by CITY



Plaintiff's exhibit 30

Source: The Texas Housing
Affordability Index
Texas Real Estate Research Center

Average Price Of Homes Sold



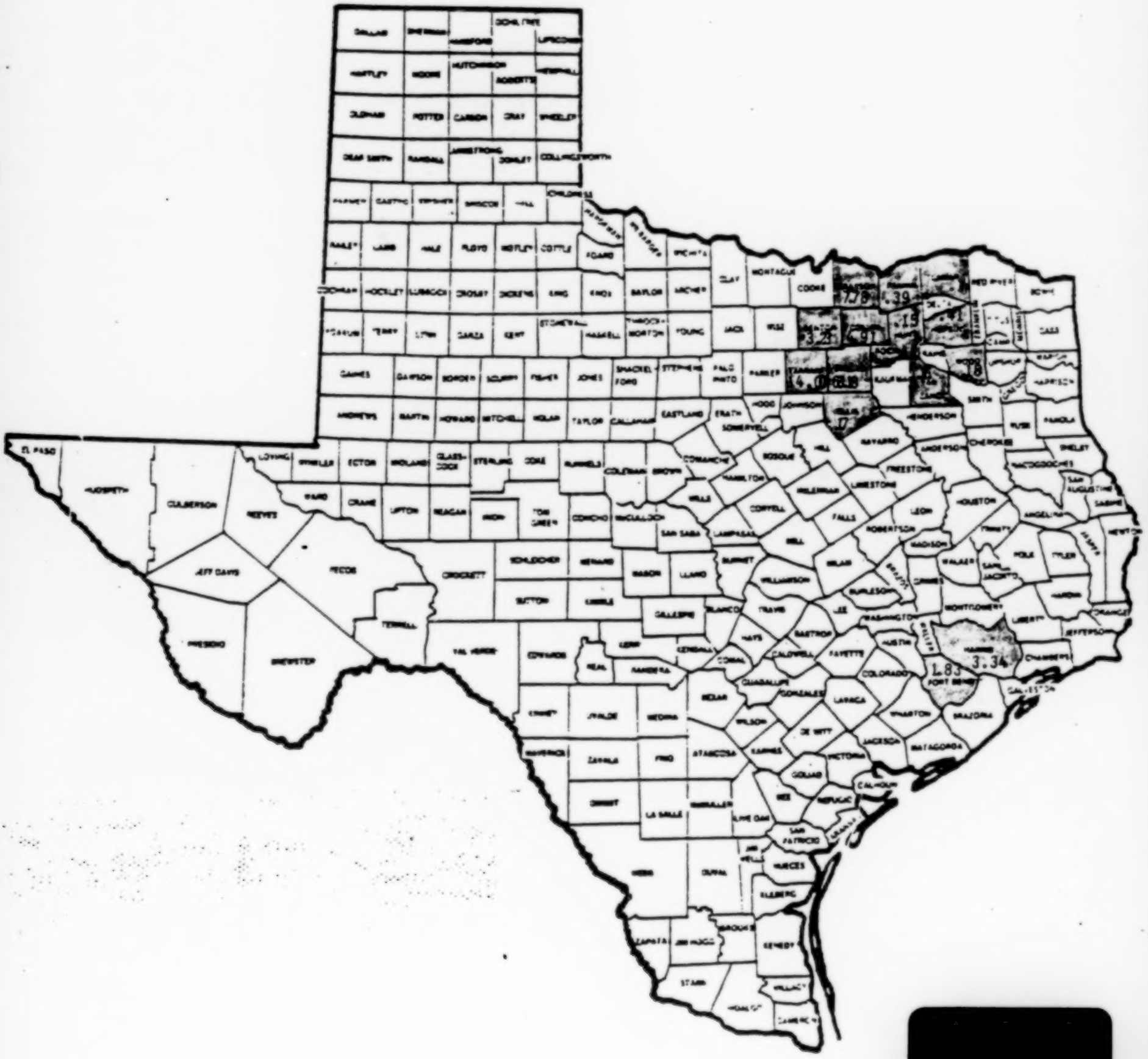
Plaintiff's exhibit 31

Source: The Texas Housing Affordibility Index
Texas Real Estate Research Center

BREAKDOWN OF % VOLUME BY COUNTY

OF LOAN PORTFOLIO PURCHASED

BY FNMA



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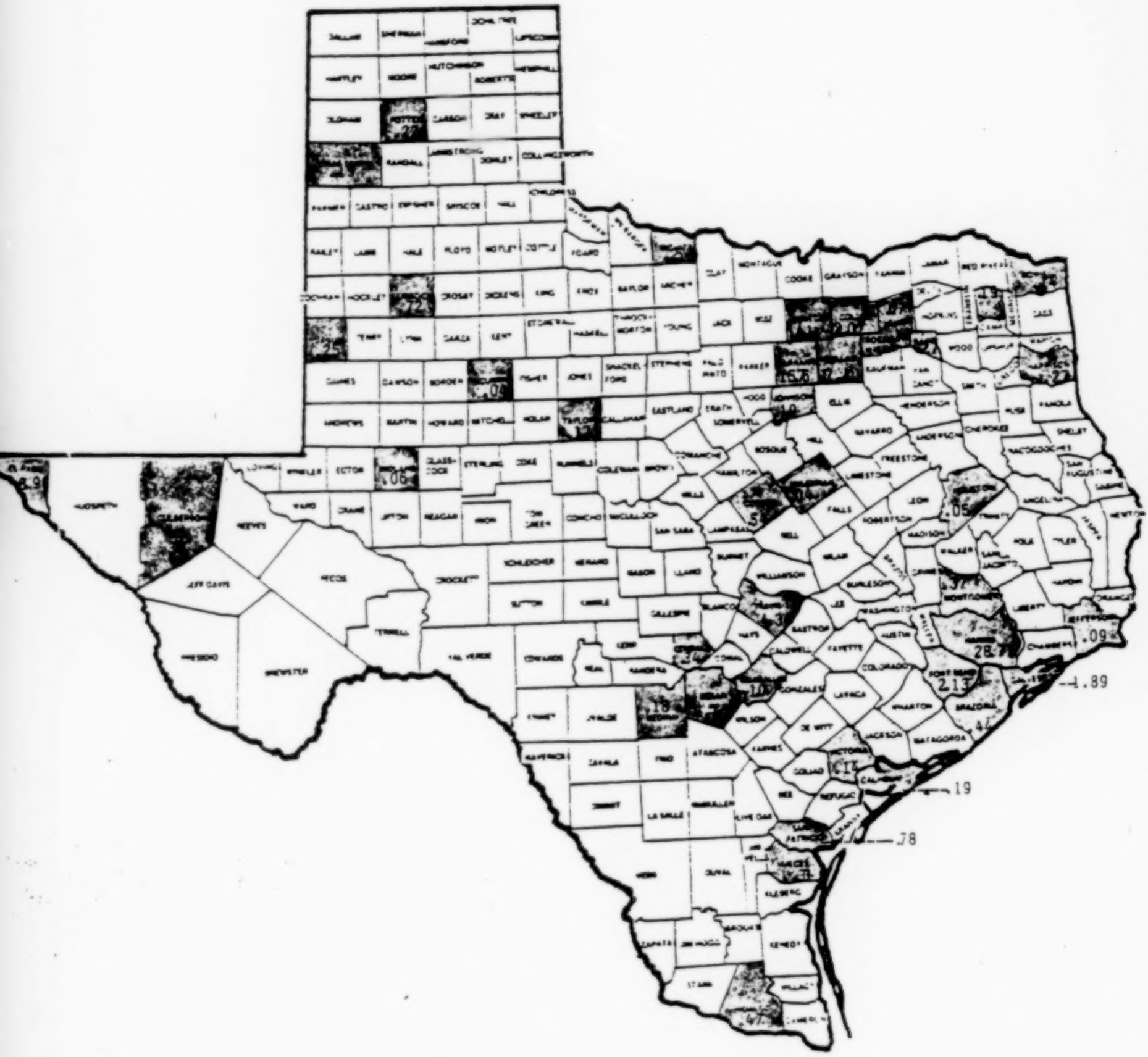
7-8-87

BREAKDOWN OF % VOLUME BY COUNTY

OF LOAN PORTFOLIO PURCHASED

BY CENTENNIAL

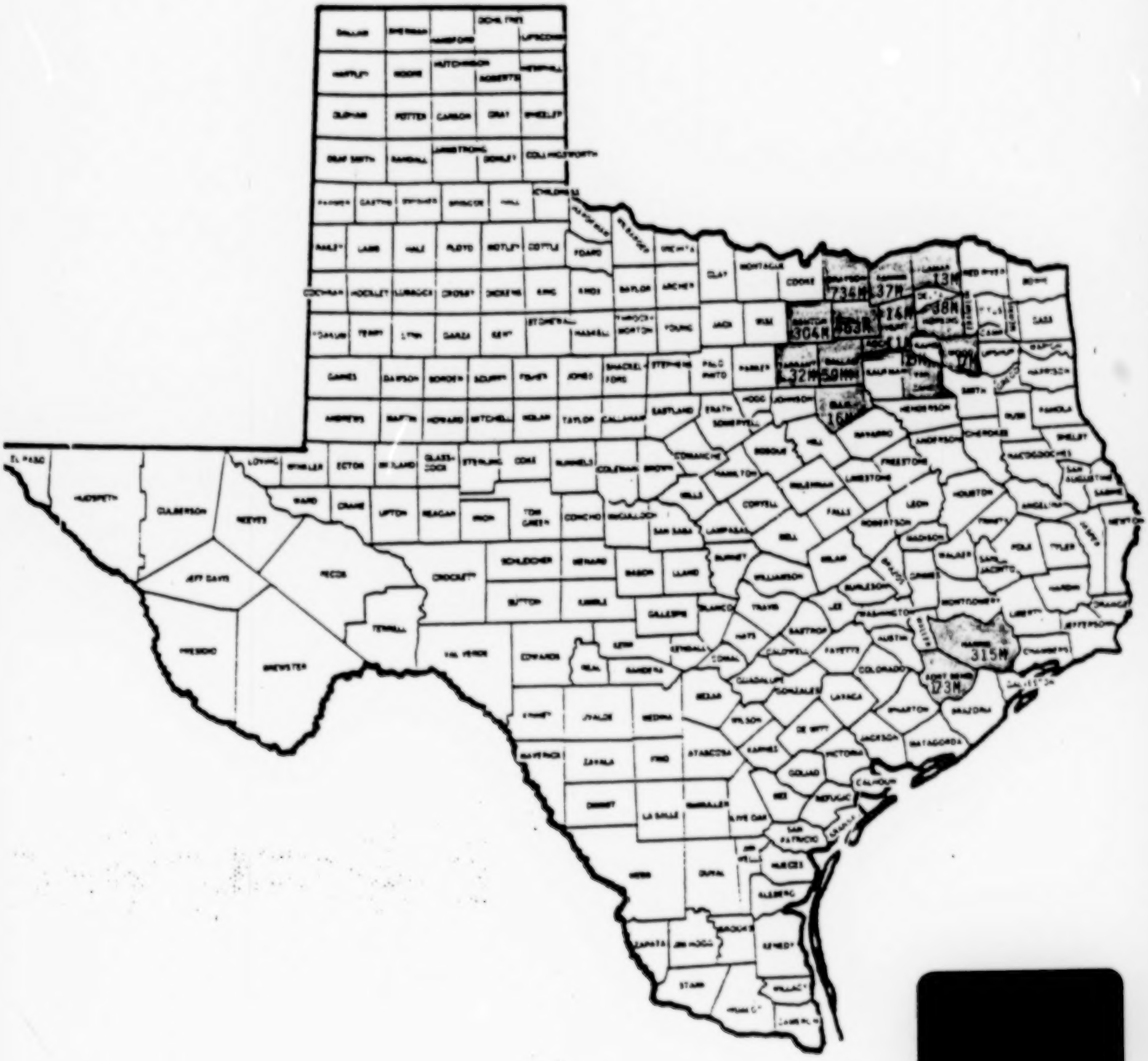


7-8-87

BREAKDOWN OF $ VOLUME BY COUNTY

OF LOAN PORTFOLIO PURCHASED

BY FNMA



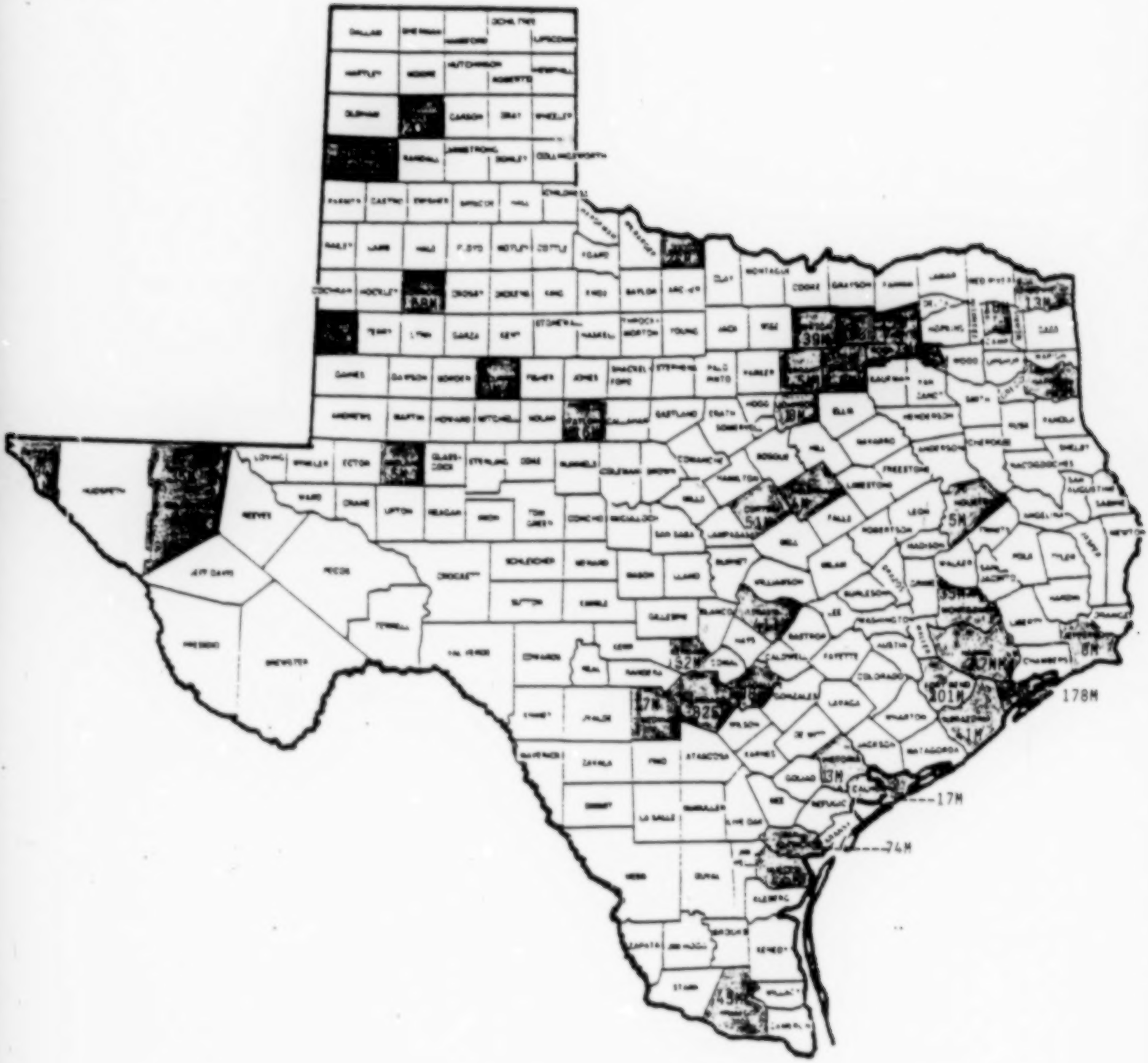
[redacted]

7-8-87

BREAKDOWN OF $ VOLUME BY COUNTY

OF LOAN PORTFOLIO PURCHASED

BY CENTENNIAL



7-8-87

Plaintiff's Exhibit 48

COMPARISONS OF CERTAIN DIFFERENCES WITHIN THE FNMA AND CENTENNIAL LOAN PORTFOLIOS

	Purchased By FNMA	Purchased By Centennial	% Dif. to Centennial	Absolute Difference to Centennial
1. Total # Loans	420	377	(10.2%)	(43)
Avg Bal/All Loans	$22,437.20	$24,996.36	11.4%	$2,559.16
2. Geographical Differences				
# Counties	15	40	166.7%	25
# 1970 SMSA's	5	17	240.0%	12
# 1981 SMSA's	4	19	375.0%	15
# Cities/Towns	45	81	80.0%	36
# Neighborboods (Zip Codes)	92	165	79.3%	73
3. Loan Servicing				
# Companies Servicing	1	76	7500.0%	75

Plaintiff's Exhibit 48 – Continued

COMPARISONS OF CERTAIN DIFFERENCES WITHIN THE FNMA AND CENTENNIAL LOAN PORTFOLIOS

	Purchased By FNMA	Purchased By Centennial	% Dif. to Centennial	Absolute Difference to Centennial
4. FHA/VA Loans				
# FHA Loans	272	258	(5.2%)	(14)
# VA Loans	63	41	(34.9%)	(22)
# FHA & VA Loans	335	299	(10.8%)	(36)
# FHA & VA Urban Loans	137	27	(80.3%)	(110)
# FHA & VA Non-Urban Loans	198	272	37.4%	74
$ FHA & VA Urban Loans	$2,401,548.94	$ 282,382.51	(88.2%)	($2,119,166.43)
$ FHA & VA Non-Urban Loans	$4,071,084.51	$6,190,247.31	52.1%	$2,119,162.80
Avg $ Bal/FHA & VA	$ 19,321.29	$ 21,647.59	12.0%	$ 2,326.30
Avg $ Bal/FHA	$ 17,790.78	$ 18,756.16	5.4%	$ 965.38

Plaintiff's Exhibit 48 – Continued

COMPARISONS OF CERTAIN DIFFERENCES WITHIN THE FNMA AND CENTENNIAL LOAN PORTFOLIOS

	Purchased By FNMA	Purchased By Centennial	% Dif. to Centennial	Absolute Difference to Centennial
Avg $ Bal/VA	$ 25,929.22	$ 39,842.45	53.7%	$ 13,913.23
Avg $ Bal/FHA & VA Urban	$ 17,529.55	10,458.61	(40.3%)	($ 7,070.94)
Avg $ Bal/FHA & VA Non-Urban	$ 20,561.03	$ 22,758.26	10.7%	$ 2,197.23
5. Conventional Loans				
# Loans	85	78	(8.2%)	(7)
# Conv. Urban Loans	11	2	(81.8%)	(9)
# Conv. Non-Urban Loans	74	76	2.7%	2
$ Conv. Urban Loans	$ 367,892.20	$ 32,271.79	(91.2%)	($ 335,620.41)
$ Conv. Non-Urban Loans	$2,583,098.31	$2,918,724.67	13.0%	$ 335,626.36

Plaintiff's Exhibit 48 – Continued

COMPARISONS OF CERTAIN DIFFERENCES WITHIN THE FNMA AND CENTENNIAL LOAN PORTFOLIOS

	Purchased By FNMA	Purchased By Centennial	% Dif. to Centennial	Absolute Difference to Centennial
Avg $ Bal/Conventional	$ 34,717.54	$ 37,833.29	9.0%	$ 3,115.75
Avg $ Bal/Conv. Urban	$ 33,444.75	$ 16,135.90	(51.8%)	($ 17,308.85)
Avg $ Bal/Corv. Non-Urban	$ 34,906.73	$ 38,404.27	10.0%	$ 3,497.54
6. Average "Housing Ratio":**				
All Loans	18%	20%	11.1%	2
Conventional Only	21%	20%	(4.8%)	(1)
FHA Only	17%	20%	17.7%	3
VA Only	19%	22%	15.8%	3
7. Average "Net Worth Per Household":**				
All Loans	$18,216	$ 25,335	39.1%	$ 7,119.00*
Conventional Only	$39,701	$32,708	(17.6%)	($ 6,993.00)
FHA Only	$12,554	$ 16,798	33.8%	$ 4,244.00
VA Only	$14,581	$ 57,790	290.3%	$43,209.00

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Plaintiff's Exhibit 48 – Continued

COMPARISONS OF CERTAIN DIFFERENCES WITHIN THE FNMA AND CENTENNIAL LOAN PORTFOLIOS

	Purchased By FNMA	Purchased By Centennial	% Dif. to Centennial	Absolute Difference to Centennial
8. Average "Income Per Household":**				
All Loans	$ 1,343	$ 1,432	6.6%	$ 89.00
Conventional Only	$ 1,932	$ 2,222	15.0%	$ 290.00
FHA Only	$ 1,128	$ 1,165	3.3%	$ 37.00
VA Only	$ 1,418	$ 1,828	28.9%	$ 410.00
9. Pre-Payment History Loan Balance as of 11/30/86:				
All Loans	$5,991,609.11	$6,704,017.61	11.9%	$712,408.50
Conventional	$1,694,534.95	$2,036,942.82	20.2%	$342,407.87
FHA/VA	$4,297,074.16	$4,667,074.79	8.6%	$370,000.63

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Plaintiff's Exhibit 48 – Continued

COMPARISONS OF CERTAIN DIFFERENCES WITHIN THE FNMA AND CENTENNIAL LOAN PORTFOLIOS

	Purchased By FNMA	Purchased By Centennial	% Dif. to Centennial	Absolute Difference to Centennial
# Loans Outstanding as of 11/30/86:				
All Loans	311	306	(1.6%)	(5)
Conventional	54	60	9.0%	6
FHA/VA	257	246	(4.3%)	(11)
Avg Bal Outstanding as of 11/30/86:				
All Loans	$ 19,265.62	$ 21,908.55	13.7%	$ 2,642.93
Conventional	$ 31,380.28	$ 33,949.05	8.2%	$ 2,568.77
FHA/VA	$ 16,720.13	$ 18,971.85	13.5%	$ 2,251.72

* These averages do not include one net worht of $3,219,113 which distorted the average.
** These ratios are taken from Tabs II-C and II-C, the sorts by Loan Type and Rate.

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Plaintiff's Exhibit 54

Summary of Plaintiff's Exhibits Nos. 3 and 5
(Conventional Loans)

Interest Rate Loan Type	Remaining Years to Maturity	Loan to Value Ratio	Aggregate Principal Balance of Loans Centennial Sold to FNMA	Aggregate Principal Balance of Loans FNMA Sold to Centennial	Number of Loans Centennial Sold to FNMA	Average Principal Balance of Loans Centennial Sold to FNMA	Number of Loans FNMA Sold to Centennial	Average Principal Balance of Loans FNMA Sold to Centennial
7.750 Con.	22 (253-264 mos.)	80.01-90	31,303.25	31,022.37	1	31,303	1	31,022
	23 (265-276 mos.)	80.01-90	30,680.50	31,225.94	1	30,681	1	31,226
7.875 Con.	18 (205-216 mos.)	70.01-80	22,712.21	22,940.71	1	22,712	2	11,470
	22 (253-264 mos.)	80.01-90	58,611.00	58,691.76	2	29,306	2	29,346
8.750 Con.	24 (277-288 mos.)	80.01-90	33,126.12	32,554.20	1	33,126	1	32,554
	26 (301-312 mos.)	80.01-90	39,515.82	40,492.45	2	19,758	1	40,492
		90.01-95	28,934.98	28,530.87	1	28,935	1	28,531
8.875 Con.	26 (301-312 mos.)	70.01-80	50,210.32	51,427.26	1	50,210	2	25,714
		90.01-95	179,310.69	174,952.05	5	35,862	5	34,990
9.000 Con.	23 (265-276 mos.)	80.01-90	42,537.67	43,174.71	1	42,538	2	21,587
	25 (289-300 mos.)	80.01-90	26,286.77	26,192.04	1	26,287	1	26,192
		90.01-95	149,719.66	153,438.82	6	24,953	4	38,350

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Plaintiff's Exhibit 54—Continued

Summary of Plaintiff's Exhibits Nos. 3 and 5
(Conventional Loans)

Interest Rate Loan Type	Remaining Years to Maturity	Loan to Value Ratio	Aggregate Principal Balance of Loans Centennial Sold to FNMA	Aggregate Principal Balance of Loans FNMA Sold to Centennial	Number of Loans Centennial Sold to FNMA	Average Principal Balance of Loans Centennial Sold to FNMA	Number of Loans FNMA Sold to Centennial	Average Principal Balance of Loans FNMA Sold to Centennial
	26 (301-312 mos.)	70.01-90	76,012.50	77,684.31	2	38,006	3	25,895
		80.01-90	332,762.67	327,325.49	8	41,595	8	40,916
		90.01-95	115,217.20	112,531.01	3	38,406	3	37,510
	27 (313-324 mos.)	70.01-80	30,087.48	30,792.78	1	30,087	1	30,793
		80.01-90	198,259.20	202,093.12	6	33,043	5	40,419
		90.01-95	196,619.99	201,535.15	6	32,770	4	50,384
9.125 Con.	26 (301-312 mos.)	70.01-80	32,457.26	31,829.23	1	32,457	1	31,829
		80.01-90	89,729.45	88,065.45	2	44,865	2	44,033
		90.01-95	172,706.48	173,964.02	5	34,541	4	43,491
9.250 Con.	25 (289-300 mos.)	90.01-95	36,074.14	36,958.97	1	36,074	1	36,959
	26 (301-312 mos.)	90.01-95	96,480.40	98,743.59	4	24,120	3	32,915
	27 (313-324 mos.)	80.01-90	66,553.08	65,556.19	2	33,277	1	65,556
		90-01-95	193,664.76	188,942.83	7	27,666	4	47,236

Plaintiff's Exhibit 54—Continued

Summary of Plaintiff's Exhibits Nos. 3 and 5
(Conventional Loans)

Interest Rate Loan Type	Remaining Years to Maturity	Loan to Value Ratio	Aggregate Principal Balance of Loans Centennial Sold to FNMA	Aggregate Principal Balance of Loans FNMA Sold to Centennial	Number of Loans Centennial Sold to FNMA	Average Principal Balance of Loans Centennial Sold to FNMA	Number of Loans FNMA Sold to Centennial	Average Principal Balance of Loans FNMA Sold to Centennial
9.375 Con.	28 (325-336 mos.)	60.01-70	58,897.83	60,345.47	1	58,898	2	30,173
		70.01-80	181,160.31	176,922.48	3	60,386	3	58,974
9.500 Con.	28 (325-336 mos.)	70.01-80	158,079.79	158,070.63	3	52,693	4	39,518
		90.01-95	41,222.08	40,268.95	1	41,222	1	40,269
9.750 Con.	25 (289-300 mos.)	90.01-95	57,966.97	57,896.17	2	28,983	2	28,948
9.875 Con.	27 (313-324 mos.)	90.01-95	124,090.08	126,827.44	4	31,023	3	42,276

Summary of Plaintiff's Exhibits Nos. 4 and 6
(FHA and VA Loans)

Interest Rate Loan Type	Remaining Years to Maturity	Aggregate Principal Balance of Loans Centennial Sold to FNMA	Aggregate Principal Balance of Loans FNMA Sold to Centennial	No. of Loans Centennial Sold to FNMA	Average Principal Balance of Loans Centennial Sold to FNMA	No. of Loans FNMA Sold to Centennial	Average Principal Balance of Loans FNMA Sold to Centennial
6.750 FHA	13 (145-156 mos.)	11,246.88	11,304.53	1	11,247	2	5,652
	18 (205-216 mos.)	463,421.93	463,425.57	30	15,447	28	16,550
7.000 FHA	20 (229-240 mos.)	24,683.04	24,685.50	1	24,683	2	12,343
	21 (241-252 mos.)	758,847.06	758,846.12	41	18,508	36	21,079
	22 (253-264 mos.)	932,535.14	932,534.33	50	18,651	51	18,285
7.000 VA	20 (229-240 mos.)	60,909.23	62,297.33	3	20,303	2	31,149
	22 (253-264 mos.)	42,278.41	42,873.53	1	42,278	3	14,291
7.500 FHA	17 (193-204 mos.)	18,068.38	18,047.39	1	18,068	2	9,024
	18 (205-216 mos.)	370,964.73	370,945.82	23	16,129	21	17,664
	19 (217-228 mos.)	217,834.72	217,830.25	13	16,757	10	21,783
	20 (229-240 mos.)	16,334.56	16,341.00	1	16,335	2	8,171
8.000 FHA	20 (229-240 mos.)	75,493.24	75,493.19	5	15,099	7	10,785
8.250 FHA	23 (265-276 mos.)	14,293.20	14,300.42	1	14,293	2	7,150
8.250 VA	23 (265-276 mos.)	276,005.95	282,737.65	12	23,000	7	40,391
8.500 FHA	14 (157-168 mos.)	14,570.32	14,493.76	1	14,570	2	7,247
	19 (217-228 mos.)	32,025.56	32,009.55	2	16,013	3	10,670

Summary of Plaintiff's Exhibits Nos. 4 and 6—Continued
(FHA and VA Loans)

Interest Rate Loan Type	Remaining Years to Maturity	Aggregate Principal Balance of Loans Centennial Sold to FNMA	Aggregate Principal Balance of Loans FNMA Sold to Centennial	No. of Loans Centennial Sold to FNMA	Average Principal Balance of Loans Centennial Sold to FNMA	No. of Loans FNMA Sold to Centennial	Average Principal Balance of Loans FNMA Sold to Centennial
8.500 FHA	20 (229-240 mos.)	781,991.47	781,990.85	48	16,291	42	18,619
	24 (277-288 mos.)	77,682.50	77,683.61	4	19,421	5	15,537
	25 (289-300 mos.)	555,404.71	555,369.27	24	23,142	22	25,244
	26 (301-312 mos.)	141,372.45	141,375.84	7	20,196	6	23,563
8.500 VA	24 (277-288 mos.)	338,331.61	346,587.96	14	24,167	8	43,323
	25 (289-300 mos.)	339,143.41	331,044.02	12	28,262	7	47,292
	26 (301-312 mos.)	32,557.71	31,943.58	1	32,558	1	31,944
8.750 VA	24 (277-288 mos.)	69,127.78	67,633.31	2	34,564	2	33,817
9.000 FHA	15 (169-180 mos.)	17,513.40	17,598.90	1	17,513	1	17,599
	25 (289-300 mos.)	242,107.23	242,185.49	14	17,293	10	24,216
9.000 VA	25 (289-300 mos.)	370,746.81	361,774.56	12	30,896	8	45,222
9.500 FHA	24 (277-288 mos.)	72,702.25	72,628.09	4	18,175	4	18,157
9.500 VA	24 (277-288 mos.)	104,439.77	106,648.40	6	17,407	3	35,549

Plaintiff's exhibit 56

7% and 8.25% VA Loans FNMA Sold to Centennial

Loan Number	Remaining Term to Maturity	Principal Balance as of 4/81	Original Loan Amount	VA Guarantee	% of Guarantee on Principal Balance as of 4/81
1428496293	253-264 mos.	23,057.41	26,000.00*	12,500	54.2
1428330970	253-264 mos.	14,770.05	16,700.00*	10,020*	67.8*
1428353659	253-264 mos.	5,046.07	5,700.00	3,420	67.8
1428157689	229-240 mos.	33,510.84	39,500.00	12,500	37.3
1428555764	229-240 mos.	28,786.49	34,275.00	12,500	43.4
1428645648	265-276 mos.	44,605.21	48,000.00*	12,500	28.0
1428769693	265-276 mos.	43,251.68	46,600.00	12,500	28.9
1428636221	265-276 mos.	41,819.39	45,000.00	12,500	29.9
1428660519	265-276 mos.	40,838.27	44,000.00*	12,500	30.6
1428643212	256-276 mos.	40,800.61	44,000.00	12,500	30.6
1428631192	265-276 mos.	40,793.74	44,000.00*	12,500	30.6
1428671142	265-276 mos.	30,628.75	33,000.00	12,500	40.8
	Total	378,908.51	Total	138,440	Weighted Average 36.5

* Based on projection rather than actual loan data.

7% and 8.25% VA Loans Centennial Sold to FNMA

Loan Number	Remaining Term to Maturity	Principal Balance as of 4/81	Original Loan Amount	VA Guarantee	% of Guarantee on Principal Balance as of 4/81
7841000006	253-264 mos.	42,278.41	48,000.00	12,500	29.6
7841000002	229-240 mos.	23,999.28	27,900.00	12,500	52.1
7841000004	229-240 mos.	19,311.14	22,500.00*	12,500	64.7
7844100003	229-240 mos.	17,598.81	20,500.00*	12,300*	69.9*
7841000022	265-276 mos.	32,393.07	34,900.00	12,500	38.6
7841000007	265-276 mos.	28,379.01	30,575.00	12,500	44.0
7841000023	265-276 mos.	26,049.87	28,100.00	12,500	48.0
7841000027	265-276 mos.	24,626.40	26,500.00	12,500	50.8
7841000026	265-276 mos.	23,900.28	25,750.00	12,500	52.3
7841000014	265-276 mos.	22,016.65	23,750.00	12,500	56.8
7841000013	265-276 mos.	21,993.71	23,725.00	12,500	56.8
7841000017	265-276 mos.	21,838.47	23,500.00*	12,500	57.2

* Based on projection rather than actual loan data.

7% and 8.25% VA Loans Centennial Sold to FNMA – Continued

Loan Number*	Remaining Term to Maturity	Principal Balance as of 4/81	Original Loan Amount	VA Guarantee	% of Guarantee on Principal Balance as of 4/81
7841000016	265-276 mos.	20,909.07	22,500.00*	12,500	59.8
7841000018	265-276 mos.	19,050.48	20,500.00	12,300	64.6
7841000008	265-276 mos.	18,121.23	19,500.00	11,700	64.6
7841000010	265-276 mos.	16,727.71	18,000.00	10,800	64.6
	Total	379,193.59	Total	197,100	Weighted Average 52.5

* Based on projection rather than actual loan data.

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PLAINTIFF'S EXHIBIT NO. 57

SUMMARY OF 1980 CENSUS DATA

	% or persons 5 years and over who reside in same house in 1975	% or persons 5 years and over who lived in a different house in same county in 1975	% of persons 5 years and over who lived outside of county in 1975	% of Centennial's Portfolio	% of FNMA's Portfolio
Bexar	50.7	28.6	20.7	8.7532	–
Bowie	53.1	27.0	19.9	0.1372	–
Brazoria	43.8	22.1	34.1	0.4352	–
Calhoun	52.3	24.2	24.5	0.1909	–
Collin	35.9	17.6	46.5	2.0688	4.9088
Coryell	23.1	8.7	68.2	0.5447	–
Culberson	55.7	24.3	20.0	0.3754	–
Dallas	44.2	33.0	22.8	17.4139	63.1798
Deaf Smith	48.5	27.5	24.0	0.1919	–
Denton	33.0	19.0	48.0	0.4140	3.2276
El Paso	50.4	26.3	23.3	8.9589	–
Ellis	52.1	21.7	26.2	–	0.1650
Fannin	55.1	21.8	23.1	–	0.3895
Fort Bend	37.9	14.7	47.4	2.1305	1.8342
Galveston	50.2	25.1	23.7	1.8886	–
Grayson	48.0	25.2	26.8	–	7.7837

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PLAINTIFF'S EXHIBIT NO. 57 – Continued

SUMMARY OF 1980 CENSUS DATA

	% or persons 5 years and over who reside in same house in 1975	% or persons 5 years and over who lived in a different house in same county in 1975	% of persons 5 years and over who lived outside of county in 1975	% of Centennial's Portfolio	% of FNMA's Portfolio
Guadalupe	50.0	17.8	32.2	1.0428	–
Harris	41.8	32.2	26.0	28.7070	3.3437
Harrison	55.1	20.2	24.7	0.2701	–
Hidalgo	59.7	23.6	16.7	0.4733	–
Hopkins	50.1	26.9	23.0	–	0.4070
Houston	51.0	20.4	28.6	0.0535	–
Hunt	48.4	23.0	28.5	0.0707	0.1517
Jefferson	56.2	28.0	15.8	0.0896	–
Johnson	48.3	21.7	30.0	0.1868	–
Kendall	54.0	19.0	27.0	0.3390	–
Lamar	50.9	30.6	18.5	–	0.1357
Lubbock	40.6	29.8	29.6	0.7237	–
McLennan	48.7	27.8	23.5	0.0379	–
Medina	65.7	17.1	17.2	0.1834	–
Midland	45.6	22.0	32.4	0.0559	–
Montgomery	41.0	25.4	33.6	0.3667	–

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PLAINTIFF'S EXHIBIT NO. 57 – Continued

SUMMARY OF 1980 CENSUS DATA

	% or persons 5 years and over who reside in same house in 1975	% or persons 5 years and over who lived in a different house in same county in 1975	% of persons 5 years and over who lived outside of county in 1975	% of Centennial's Portfolio	% of FNMA's Portfolio
Nueces	50.5	27.4	22.1	1.3310	–
Potter	49.6	22.6	27.8	0.2163	–
Rains	50.2	17.1	32.7	0.2663	–
Rockwall	36.8	12.4	50.8	0.1363	0.1158
San Patricio	51.0	20.8	28.2	0.7836	–
Scurry	55.0	18.2	26.8	0.0360	–
Tarrant	44.6	30.0	25.4	15.7634	14.0086
Taylor	42.1	24.9	33.0	0.1732	–
Titus	52.1	23.4	24.5	0.1882	–
Travis	36.2	28.8	35.0	4.3639	–
Van Zandt	56.1	16.8	27.1	–	0.1640
Victoria	50.2	26.7	23.1	0.1361	–
Wichita	43.3	27.9	28.8	0.2526	–
Wood	49.9	19.4	30.7	–	0.1849
Yoakum	51.5	20.8	27.7	0.2495	–

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PLAINTIFF'S EXHIBIT NO. 57 – Continued

SUMMARY OF 1980 CENSUS DATA

FNMA

Weighted average of % of persons 5 years and over who resided in same house in 1975: 43.7%

CENTENNIAL

Weighted average of % of persons 5 years and over who resided in same house in 1975: 48.8%

% of difference:

11.7%

DEFENDANT'S EXHIBIT NO. 8

FEDERAL HOME LOAN BANK BOARD
OFFICE OF EXAMINATIONS AND SUPERVISION

MEMORANDUM

June 27, 1980

TO: OES Professional Staff
FROM: L. David Taylor

"Reciprocal Sales" of Mortgage Loans

SYNOPSIS: A LOSS NEED NOT BE RECORDED FROM "RECIPROCAL SALES" OF SUBSTANTIALLY IDENTICAL MORTGAGE LOANS.

The purpose of this memorandum is to advise OES staff on the proper accounting for reciprocal sales of mortgage loans.

A loss resulting from a difference between market value and book value in connection with reciprocal sales of substantially identical mortgage loans need not be recorded. Mortgage loans are considered substantially identical only when each of the following criteria is met. The loans involved must

1. involve single-family residential mortgages,
2. be of similar type (e.g., conventionals for conventionals),
3. have the same stated terms to maturity (e.g., 30 years),
4. have identical stated interest rates,
5. have similar seasoning (i.e., remaining terms to maturity),
6. have aggregate principal amounts within the lesser of 2½% or $100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,

7. be sold without recourse,
8. have similar fair market values,
9. have similar loan-to-value ratios at the time of the reciprocal sale, and
10. have all security properties for both sides of the transaction in the same state.

When the aggregate principal amounts are not the same and the principal amount of the mortgage loans purchased is greater than the principal amount of the mortgage loans sold, the purchaser should record the additional principal. The difference between the additional principal and the additional cost should be recorded as a discount and amortized over a period of not less than ten years. If the principal amount of the mortgage loans purchased is less than the principal amount of those originally sold, the purchaser should reduce its loan account. The difference between the reduction in loans and the amount of cash received should be charged to loss on sale of mortgage loans.

If a reciprocal sale does not meet all of the above criteria, the institution must record losses resulting from the sale.

/s/ L. David Taylor
Director

Distribution to state supervisory authorities to be made by District Directors-Examinations.

DEFENDANT'S EXHIBIT NO. 60

L. David Taylor, Director — August 10, 1981

John Buchanan, Executive Staff Director
Liberalization of R-49

An advisory council resolution requests the FHLBB to "Liberalize R-49 pertaining to 'like assets' to be compatible with IRS definition, to facilitate mortgage swaps." This memorandum restates and expands the discussion of this matter as previously submitted to you in a memorandum from F. Passarelli dated July 16, 1980. OES is still opposed to complying with this resolution.

The key issues in connection with this suggestion are:

1. Will the Board's proposal to allow deferral of losses on sales of mortgages preclude the need for liberalizing R-49?
2. Can a more flexible transaction more clearly meet the requirements for tax deductibility and, in good conscience, not require recognition of losses.

ISSUE 1

This request stems from a desire of the industry to structure an exchange of mortgage loans to create a loss for income tax reporting purposes, not for financial reporting purposes. An agenda item for the August 13th Board meeting is consideration of a proposed regulation which will permit deferral of losses from the sale of certain low rate mortgages. This proposal will comply with associations' desires, without altering the substantially identical exchange provided for in Memorandum R-49.

ISSUE 2

An exchange of assets which will result in a tax deductible loss must involve assets (loans) which differ "materially in kind or in extent" (IRS Regulation 1.1001-1(a)). But to avoid the recognition of a loss under generally accepted accounting principles, the association must remain in substantially the same economic position after the swap as it was before it. Accordingly, the key issue in connection with liberalizing R-49 is whether we can liberalize the 10 listed characteristics of "like assets" defined in the memorandum but maintain mortgage swaps which the IRS will view as involving loans which differ materially in kind or extent; and at the same time would not alter the economic positions of the two associations which engage in the swap.

When developing the criteria contained in Memorandum R-49, we worked closely with the AICPA Committee on Savings and Loan Associations. In addition to communication with this committee, we also obtained agreement with our stance from prominent CPAs serving the industry. These included Walter Erikson (PMM&Co.), Mike McCarthy and Henry Forer (DH&S), and Don Zellmer (E&W). Our objective at that time was to structure a transaction which was as close as possible to the IRS "materially different" definition which would still not change the economic position of the association after it engaged in the swap. It was and remains our opinion that Memorandum R-49 represents a transaction which is on a fine line between "substantially identical" and "materially different".

These criteria represented our attempt to maintain the association's position with respect to the three types of risks in a loan portfolio. These risks relate to credit (collectibility), rate (future earnings potential), and repayment (extent of principal repayments and prepayments). In our

opinion, a change in any of these risks would change the economic factors underlying an association's loan portfolio and, as a result, require recording the resulting gain or loss.

The following schedule relates the ten criteria for non-recognition, as outlined in Memorandum R-49, to these types of risks.

		Risk		
	Criteria	Credit	Rate	Repayment
1)	involve only single family residential mortgages	x		x
2)	are similar type (conventional vs insured)	x		x
3)	same stated terms to maturity (i.e. 29 yrs)			x
4)	identical stated interest rates		x	x
5)	similar seasoning			x
6)	aggregate principal amounts within 2½% or $100,000, with difference made up in cash	x	x	x
7)	sold without recourse	x		
8)	similar fair market values	x	x	x
9)	similar loan to value ratio at time of maturity	x		
10)	security properties in same state			x

These criteria vary in importance and effect in achieving the desired objective (i.e., assuring that risk does not transfer). However, it is OES's opinion that all are neces-

sary in their present form to structure the transaction which does not trigger a loss under GAAP.

Conversely, changing the criteria would create another difference between GAAP and RAP. Finally, the line of reasoning used in R-49 is consistent with and similar to that used in developing Memorandum R-48, "Securities Transactions".

CONCLUSION

In summary it is OES's opinion 1.) that the Board's consideration of a proposed regulation permitting deferral of losses on sales of loans is a more comprehensive approach to permitting disposal of low-yielding loans without recognizing the realized loss and 2.) that altering the criteria in R-49 would result in either no tax benefits or a transaction requiring the recording of losses. Accordingly, we advise against liberalizing the criteria contained in Memorandum R-49.

/s/
Director

Supreme Court of the United States

No. 89-1926

UNITED STATES, PETITIONER

v.

CENTENNIAL SAVINGS BANK, FSB
(RESOLUTION TRUST CORPORATION, RECEIVER)

ORDER ALLOWING CERTIORARI. Filed October 1, 1990.

The petition herein for a writ of certiorari to the United States Court of Appeals for the Fifth Circuit is granted. This case is set for oral argument in tandem with No. 89-1965, *Cottage Savings Association* v. *Commissioner of Internal Revenue*.

October 1, 1990

PETITIONER'S

BRIEF

Supreme Court, U.S.
FILED
NOV 15 1990
JOSEPH F. SPANIOL, JR.

No. 89-1926

In the Supreme Court of the United States

OCTOBER TERM, 1990

UNITED STATES OF AMERICA, PETITIONER

v.

CENTENNIAL SAVINGS BANK FSB
(RESOLUTION TRUST CORPORATION, RECEIVER)

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTIONS PRESENTED

1. Whether a financial institution realizes a deductible loss for income tax purposes when it exchanges a group of mortgage loans for a substantially identical group of mortgage loans held by another financial institution.

2. Whether income received by a financial institution from its depositors as penalties for early withdrawal of their funds is excludable from gross income as income from "the discharge * * * of indebtedness," within the meaning of Section 108 of the Internal Revenue Code.

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In the Supreme Court of the United States

OCTOBER TERM, 1990

No. 89-1926

UNITED STATES OF AMERICA, PETITIONER

v.

CENTENNIAL SAVINGS BANK FSB
(RESOLUTION TRUST CORPORATION, RECEIVER)

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-29a) is reported at 887 F.2d 595. The opinion of the district court (Pet. App. 30a-60a) is reported at 682 F. Supp. 1389.

JURISDICTION

The judgment of the court of appeals was entered on November 2, 1989. A petition for rehearing was denied on January 19, 1990 (Pet. App. 61a-62a). On April 10, 1990, Justice White extended the time within which to file a petition for a writ of certiorari to and including May 18, 1990. On May 4, 1990, Justice White further extended that time to and including June 8, 1990. The petition was filed on June 8, 1990, and was granted on October 1, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS AND REGULATION INVOLVED

The relevant portions of Sections 108, 165, and 1001 of the Internal Revenue Code of 1954 (26 U.S.C. (1982)) and Section 1.1001-1(a) of the Treasury Regulations on Income Tax (26 C.F.R.) are set forth at Pet. App. 63a-66a.

STATEMENT

1. a. Respondent is a mutual savings and loan association formerly regulated by the Federal Home Loan Bank Board.[1] In 1981, respondent's mortgage loan portfolio was comprised primarily of fixed-rate, long-term home mortgage loans that had been issued in the late 1960s at interest rates significantly lower than those charged on more recent loans. As a result of the high interest rates of the late 1970s and early 1980s, the fair market value of these older, low-interest loans fell far below their face amount. Pet. App. 31a.

For respondent, like other savings institutions holding older, low-interest loans, this situation created a tax incentive for disposing of its depreciated mortgage loans. A disposition of the loans would enable an institution to realize for tax purposes the loss that resulted from these market changes; the institution could then utilize the resulting loss deductions to offset current taxable income and produce loss carrybacks that would generate tax refunds from prior years. There was, however, a problem with a straightforward disposition of the depreciated mortgage loans. Many of these institutions were in such precarious financial condition that a sale of the loans and consequent recognition of the losses—however beneficial for tax purposes—would for regulatory accounting purposes have caused them to fail to meet the Bank Board's minimum reserve and liquidity requirements. See Pet. App. 31a-32a; *San Antonio Savings Ass'n* v.

[1] In 1989, the Federal Home Loan Bank Board was abolished by statute, and many of its functions were transferred to other federal agencies, including the Office of Thrift Supervision and the Federal Deposit Insurance Corporation. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. 101-73, § 401, 103 Stat. 354.

Commissioner, 887 F.2d 577, 579 (5th Cir. 1989), petition for cert. pending, No. 89-1928.

On June 27, 1980, the Bank Board's Office of Examination and Supervision (OES) issued Memorandum R-49, a regulatory accounting principle that adopted the rule that savings institutions could make "reciprocal sales" of depreciated "substantially identical mortgage loans" without having to record a loss for regulatory accounting purposes. J.A. 55-56. Memorandum R-49 established a list of ten criteria that would render loans "substantially identical," including that the mortgages be of similar type with the same terms and interest rates.[2] The admitted objective of Memorandum R-49 was to allow savings institutions to engage in transactions that would generate deductible losses for federal income tax purposes, but that would not be treated as giving rise to losses for financial reporting and regulatory purposes. *San Antonio Savings Ass'n* v. *Commissioner*, 887 F.2d at 579-580; J.A. 57-60.[3]

[2] Memorandum R-49 provided in part (J.A. 55-56):

A loss resulting from a difference between market value and book value in connection with reciprocal sales of substantially identical mortgage loans need not be recorded. Mortgage loans are considered substantially identical only when each of the following criteria is met. The loans involved must:

1. involve single-family residential mortgages,
2. be of similar type (e.g., conventionals for conventionals),
3. have the same stated terms to maturity (e.g., 30 years),
4. have identical stated interest rates,
5. have similar seasoning (i.e., remaining terms to maturity),
6. have aggregate principal amounts within the lesser of 2 ½% or $100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,
7. be sold without recourse,
8. have similar fair market values,
9. have similar loan-to-value ratios at the time of the reciprocal sale, and
10. have all security properties for both sides of the transaction in the same state.

[3] A memorandum from the Director of OES to an officer of the Bank Board described the "objective" of Memorandum R-49 as being "to structure a transaction which was as close as possible to the IRS 'materially different' definition which would still not change the economic position of the associa-

On April 13, 1981, respondent entered into a transaction in which it effectively exchanged a package of interests in a group of residential mortgage loans for a package of interests in a group of residential mortgage loans held by the Federal National Mortgage Association (FNMA), a congressionally chartered, but privately owned, corporation that is the principal buyer and seller of mortgages in the secondary mortgage market. The interests were exchanged through "reciprocal sales" of conventional and Federal Housing Administration and Veterans' Administration (FHA/VA) loan packages having almost identical face and market values. The parties planned the transaction so as to ensure that the exchanged loans met the requirements of Memorandum R-49. See note 2, *supra*. FNMA used a computer to match respondent's loans with its own loans, and it then sent respondent a list of FNMA loans that it proposed to exchange for a group of respondent's loans. Respondent agreed to acquire all of the proposed loans, without conducting any new credit checks, appraisals, or underwriting of those loans, and without reviewing any of the relevant mortgage file documents. The valuation of all of the loans was established by reference to FNMA's new money auction rate for April 1981. To arrive at a sale price, one common discount factor was applied to each side of the transaction on all conventional loans and another common discount factor was applied to all FHA/VA loans. Pet. App. 2a, 33a-37a.

The transaction was styled a "reciprocal sale" and was consummated by conveyance of a 90% participation interest in each loan together with a simultaneous wire transfer of money by respondent and FNMA to each other's account.[4] Respondent thus paid FNMA $5,662,045.[5] for participation interests with a

tion after it engaged in the swap." J.A. 58; see *San Antonio Savings Ass'n* v. *Commissioner*, 887 F.2d at 580.

[4] Transactions designed to take advantage of Memorandum R-49 often involved exchanges of 90% participation interests, rather than the entire loan, so that the original mortgagee could maintain its relationship with the obligor on the loans. See *Cottage Savings Ass'n* v. *Commissioner*, 90 T.C. 372, 381 (1988), rev'd, 890 F.2d 848 (6th Cir. 1989), cert. granted, No. 89-1965 (Oct. 1, 1990).

[5] All amounts are rounded off to the nearest dollar.

face amount of $8,481,264, while at the same time FNMA paid respondent $5,662,043 for participation interests with a face amount of $8,481,261. In effect, respondent exchanged participation interests with a face amount (and cost basis) of $8,481,261, but a much lower value, for participation interests of almost exactly equal value. On its 1981 federal income tax return, respondent claimed a deduction for a loss on the transaction of $2,819,218, the difference between the face amount and value of the participation interests that it transferred. Pursuant to Memorandum R-49, however, respondent did not report any loss for financial and regulatory accounting purposes. Pet. App. 2a-3a, 34a-35a.

b. During 1981, respondent also had many certificates of deposit outstanding. Each certificate of deposit agreement established the interest rate to be paid on the deposit and a fixed term for which the depositor was to keep the funds on deposit with respondent. If a depositor chose to withdraw the principal from one of these accounts prior to maturity, federal regulations required the depositor to pay an "early withdrawal penalty" to respondent. See 12 C.F.R. 1204.103 (1981); 12 C.F.R. 526.7 (1980); 12 C.F.R. 526.7 (1979). Under the terms of the certificates, when a depositor incurred a penalty for withdrawing his deposit before expiration of the fixed term he would receive a single net payment from respondent – consisting of the principal on deposit plus interest payable to the date of withdrawal, less the penalty. The penalty thus was "paid" not by a direct transfer of funds from the depositor to respondent, but rather by subtracting the amount of the penalty from the amount paid to the depositor on the certificate. Pet. App. 11a & n.4, 54a-55a.

During 1981, respondent received $258,019 in early withdrawal penalties. On its 1981 return, respondent treated the penalties as income from the discharge of indebtedness (see 26 U.S.C. 61(a)(12)), and it excluded that amount from its gross income under Section 108 of the Code.[6] Pet. App. 4a, 55a. In

[6] Unless otherwise indicated, statutory references are to the Internal Revenue Code of 1954 (26 U.S.C. (1982)), as in effect for the years at issue (the Code or I.R.C.).

1981, that provision effectively allowed a taxpayer to defer the recognition of amounts included in gross income by reason of the discharge of indebtedness by generally providing that such income could be excluded from gross income if the taxpayer made an election under Section 1017 of the Code to reduce the basis of its depreciable property by the amount excluded.

2. On audit, the IRS determined that respondent was not entitled to its claimed deduction for a loss on the mortgage exchange transaction. The IRS further determined that respondent was required to include the early withdrawal penalties in gross income. Respondent paid the resulting income tax deficiencies and filed this refund action in the United States District Court for the Northern District of Texas. Pet. App. 3a-4a, 30a.[7] After a bench trial, the district court ruled for the government on the mortgage swap issue and for respondent on the early withdrawal penalty issue (*id.* at 30a-60a).

a. The court first determined that, even though the mortgage transaction had been structured as two simultaneous reciprocal sales, it was essentially an exchange of mortgage loans (Pet. App. 44a-47a). It then concluded that this exchange was not an event giving rise to realization of gain or loss under Section 1001 of the Code (*id.* at 47a-54a). Relying on Treasury Regulation § 1.1001-1(a) and addressing the relevant case law, the court explained that a loss is realized on an exchange of properties only if the properties are "materially different" (Pet. App. 47a-50a). The court held that, considering the "economic realities in existence *at the time of the transaction*" (*id.* at 51a), the mortgages exchanged here were not materially different, and

[7] Respondent reported a net operating loss on its 1981 return. It carried back this loss to the years 1969, 1970, and 1972-1980, resulting in claimed overpayments of taxes for those years. Respondent filed claims for tentative refunds of those overpayments, and the IRS disbursed the claimed refunds. The IRS disallowed the net operating loss claimed for 1981 and made an assessment against respondent in the amount of $788,634 plus interest. Pet. App. 3a-4a. Thus, although the two issues presented here relate to respondent's income tax liability for 1981, the amounts at issue involve the refunds claimed by respondent for earlier tax years, based on net operating loss carrybacks from 1981.

hence the exchange could not give rise to a deductible loss (*id.* at 50-54a). The court explained that the exchanged loans had been carefully selected so that they would be considered "substantially identical" under Memorandum R-49, and it concluded that "[t]he R-49 criteria assured that the mortgages after the matching process would not be materially different" (*id.* at 51a). The court recognized that each individual loan differed from the others, but it found that the " 'pools' of mortgages * * * were swapped with little if any reference to possible differences in the individual characteristics of the loans involved"; it then added that it is "difficult to attach significance to loan characteristics of which [respondent] itself had no knowledge at the time of the transaction." *Id.* at 52a.

b. The court agreed with respondent that the early withdrawal penalties were income by reason of the discharge of indebtedness that could be excluded from gross income under Section 108 of the Code (Pet. App. 54a-60a). The court stated that "the penalty provision is an integral part of the contract, not merely an ancillary 'method' or 'medium' by which the debt was reduced" and therefore "the penalty income was liquidated debt, not liquidated damages" (*id.* at 59a). The court then concluded that "income received by [respondent] from premature withdrawals was a direct result of depositors discharging [respondent] from its indebtedness to them" (*ibid.*).

3. Both parties appealed, and the court of appeals reversed the district court's decision with respect to the mortgage exchange issue and affirmed with respect to the early withdrawal penalty issue (Pet. App. 1a-29a). The case was heard together with two other cases involving mortgage exchanges that satisfied the criteria of Memorandum R-49, and all three cases were decided by the same panel on the same day. See *San Antonio Savings Ass'n* v. *Commissioner, supra*; *First Federal Savings & Loan Ass'n* v. *United States*, 887 F. 2d 593 (5th Cir. 1989), petition for cert. pending, No. 89-1927.

a. The court of appeals treated *San Antonio* as the lead case, and it held there that an exchange of mortgages that satisfied the criteria of Memorandum R-49 still could give rise

to a deductible loss for tax purposes. The court of appeals agreed with the district court and the government that a loss is realized on an exchange only if the properties exchanged are materially different (887 F.2d at 581-587). The court observed that, if the rule were otherwise, there would be "no limits on realization through meaningless exchanges," such as an exchange of different bushels of indistinguishable wheat (*id.* at 583). After an extensive review of the case law, the court concluded that "there is a material difference requirement which has been developed by the cases and confirmed by the Treasury Regulations" (*id.* at 587). The court then held, however, that the mortgages exchanged in an R-49 transaction are "materially different" because the mortgages have different borrowers and different collateral, even though the Bank Board had identified the mortgages as "substantially identical" (*id.* at 587-592). The court acknowledged that these variations made no difference to the parties to the exchange, but it stated that "[i]t must be the objective and not subjective factors, * * * which determine whether a realization event occurred" (*id.* at 590). The court also rejected the government's additional argument that the exchange lacked economic substance and therefore that no loss could be deducted under Section 165 of the Code (*id.* at 592-593).

In this case, the court of appeals observed that the facts relevant to the mortgage exchange issue were essentially the same as the facts in *San Antonio* (Pet. App. 3a). Accordingly, it held that respondent's "R-49 transaction resulted in a realized and recognizable loss for tax purposes because the participation interests exchanged were in mortgages which under the Internal Revenue Code differed materially from each other" (*id.* at 9a).

b. The court of appeals agreed with the district court that the early withdrawal penalties received by respondent constituted income from the discharge of indebtedness and therefore that respondent was entitled to defer reporting that income pursuant to Section 108 of the Code (Pet. App. 9a-28a). The court stated that the determination whether income should be regarded as "from the discharge of indebtedness" "focus[es] on the final result"—specifically, "on the spread between the

amount received by the debtor and the amount paid by him to satisfy his obligation" (*id.* at 12a). The court reasoned that this approach supported respondent's position here since the effect of the penalty was to reduce respondent's net obligation to its depositor (*ibid.*), and it found no reason to reach a different result. In so holding, the court expressly disagreed (*id.* at 28a) with the decisions of the Tax Court and the Seventh Circuit in *Colonial Savings Ass'n* v. *Commissioner*, 85 T.C. 855 (1985), aff'd, 854 F.2d 1001 (1988), cert. denied, 109 S. Ct. 1556 (1989), which had both concluded that early withdrawal penalties do not constitute income from the discharge of indebtedness that may be excluded under Section 108.[*]

INTRODUCTION AND SUMMARY OF ARGUMENT

1. Respondent and FNMA exchanged packages of mortgage loans that complied with the criteria set forth in Federal Home Loan Bank Board Memorandum R-49. Respondent claimed a loss deduction on its federal tax return equal to the difference between the face amount and value of the loans it transferred. In the Bank Board's view, mortgage loans that meet the R-49 criteria are "substantially identical" and, consequently, an exchange of such loans does not effect any change in the participants' economic position. For that reason, the Bank Board took the position in Memorandum R-49 that an exchange of such loans gives rise to no loss that need be reported for financial or regulatory accounting purposes.

The Internal Revenue Code takes increases and decreases in the value of property into account only when they are "realized" by a taxable event. See I.R.C. § 1001(a). An exchange of property is not a realization event unless it involves "property differ-

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[*] While the case was pending on appeal, respondent was found insolvent by the Bank Board, and the Federal Savings and Loan Insurance Corporation was appointed as receiver. Subsequently, the Resolution Trust Corporation (RTC) took over as receiver. By statute, the Federal Deposit Insurance Corporation "perform[s] all responsibilities" of the RTC. See Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 501, 103 Stat. 369 (to be codified at 12 U.S.C. 1441a(b)(1)(C)).

ing materially either in kind or in extent." Treas. Reg. § 1.1001-1(a). This "materially different" requirement reflects the fundamental principle of federal taxation that the substance rather than the form of a transaction determines its tax consequences. A taxpayer who exchanges property for property that is not materially different has, in form, disposed of his property. In substance, however, nothing has changed; the taxpayer is in the same economic position as before the transaction. Accordingly, gain or loss is realized on an exchange of property only if the property transferred is materially different from the property received.

Although the court below upheld the longstanding position reflected in Treas. Reg. § 1.1001-1(a) that a loss can be realized on an exchange only if the properties are "materially different," the court proceeded to eviscerate that requirement by construing the phrase "materially different" so narrowly as to render the term "materially" essentially meaningless. The court held that loans that satisfy the Memorandum R-49 criteria—*i.e.*, loans that are acknowledged to be "substantially identical"—nevertheless are "materially different" merely because the loans have different borrowers and are secured by different collateral. The court failed to explain, however, why these differences—which the Bank Board formally determined were immaterial—should be regarded as "material" for federal tax purposes. By definition, a difference is material if it has the capacity to affect a decision. The differences in borrowers and collateral on which the court below relied, however, did not matter to any of the interested parties—respondent, its trading partner, the secondary mortgage market, or the Bank Board. The court rejected the relevance of each of these views, and substituted its own rule that differences in borrowers and collateral are always material. The court's holding exalts form over substance and severely undermines the efficacy of the realization requirement by allowing differences of no consequence to any interested party to be deemed "material," thereby permitting a deductible loss for federal tax purposes to be generated by a transaction that no one regarded as changing the

participants' economic position. Indeed, the fact that there was no change in economic position was the very key to regulatory treatment of the exchange under Memorandum R-49.

2. Section 108 of the Code provides that income realized "by reason of the discharge * * * of indebtedness" may be excluded from gross income. A taxpayer may realize income from the discharge of a debt when the debt is forgiven, cancelled, or otherwise discharged for less than its face amount. Such income is excludable under Section 108 if the taxpayer elects under Section 1017 to reduce its basis in depreciable property it owns in an amount equal to the amount excluded. The tax on the debt discharge income is, in effect, deferred and collected through lower depreciation deductions for the reduced-basis assets, or through greater taxable gains on their subsequent sale.

During the taxable year in issue, respondent's depositors were required by federal regulations to pay a penalty to respondent in order to withdraw the principal from one of respondent's fixed-term accounts prior to maturity. Respondent collected these early withdrawal penalties by reducing the amount otherwise payable to the depositor by the amount of the penalty. It is undisputed that the penalties received by respondent are income. Respondent maintains, however, that the amount of the penalties constitutes income from the discharge of indebtedness excludable under Section 108. But not every debt that is cancelled or discharged results in income "*by reason of* the discharge" of the debt. I.R.C. § 108(a)(1) (emphasis added). If the cancellation of a debt is not, in and of itself, the source of the income, but simply the method by which a creditor makes a payment to a debtor, then the debtor does not have income "by reason of" a debt discharge; he has income "by reason of" receiving a payment. That income does not qualify for the Section 108 exclusion.

Here, as with the mortgage swap issue, the result reached by the court of appeals elevated form over substance. If the depositors making premature withdrawals had paid the penalty due respondent in cash, and, in turn, received from respondent the entire amount due on their accounts, then respondent would

have had income in the amount of the penalty and that income clearly would have been income not from the discharge of indebtedness, but from the payment of a penalty. The result should be no different merely because the penalty was paid by offset against the amount otherwise owed by respondent to the depositor. The cancellation of a portion of the debt owed by respondent to the depositor resulting from this offset simply was the method by which the depositor paid the penalty to respondent. Respondent did not have income "by reason of" the discharge of its indebtedness; it had income "by reason of" receiving a penalty. Although the debt owed by respondent to a depositor was "discharged" in the sense that it was extinguished, it was not discharged for less than face value. The portion of the debt that respondent did not pay to the depositor was not forgiven by the depositor, but rather was used to satisfy—*i.e.*, to pay—the penalty obligation owed by the depositor. The penalty obligation itself was created and imposed by federal regulations. Respondent's income thus did not arise "by reason of the discharge" of indebtedness within the meaning of Section 108, and therefore that income did not qualify for the exclusion provided by that statute.

ARGUMENT

1. RESPONDENT DID NOT REALIZE A DEDUCTIBLE LOSS ON THE SWAP OF ONE GROUP OF MORTGAGE LOANS FOR ANOTHER SUBSTANTIALLY IDENTICAL GROUP

Respondent's exchange of packages of mortgage loans did not produce a deductible loss because (1) in order for an exchange of property to produce a deductible loss, the property transferred must be materially different from the property received, and (2) the property transferred by respondent was not materially different from the property that it received. Although the court of appeals agreed with the first of these propositions, it erred in its analysis of the second.

A. A Deductible Loss Is Realized On An Exchange Of Property Only If The Property Transferred Is Materially Different From The Propert Received

1. It is black letter law that the Internal Revenue Code ordinarily takes into account increases and decreases in the value of property only when gains or losses are realized. Section 61(a)(3) of the Code provides that gross income includes "[g]ains derived from dealings in property." Section 165(a) of the Code allows a deduction for "loss[es] sustained during the taxable year." And Section 1001(a) of the Code provides:

> The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

Taken together, these Sections establish that a gain or loss in the value of property is ordinarily taken into account only if it is "realized"; mere increases or decreases in the value of property, without a realization event (such as a sale, exchange or other disposition of property), do not have tax consequences.[9]

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[9] See generally 2 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 40.2, at 40-4 (2d ed. 1990) [hereinafter Bittker & Lokken]. Section 1001(a) entered the tax laws as Section 202(a) of the Revenue Act of 1924, ch. 234, 43 Stat. 253. Prior to the enactment of Section 202(a), the realization requirement existed as a judicial doctrine. See *Eisner* v. *Macomber*, 252 U.S. 189, 207 (1920) (income includes "profit gained through a sale or conversion of capital assets"); *Merchants' Loan & Trust Co.* v. *Smietanka*, 255 U.S. 509, 518 (1921) (same); see also *Helvering* v. *Horst*, 311 U.S. 112, 115 (1940) ("From the beginning the revenue laws have been interpreted as defining 'realization' of income as the taxable event."). Congress did not intend that Section 202(a) would change the law. Rather, the purpose of Section 202(a) was "to show clearly the method of determining the amount of gain or loss from the sale or other disposition of property," and that method "merely embodies in the law the present construction by the [Treasury] department and the courts of the existing law." H.R. Rep. No. 179, 68th Cong., 1st Sess. 12 (1924); S. Rep. No. 398, 68th Cong., 1st Sess. 13 (1924). Earlier revenue laws had provided that "gains, profits, and income" from "dealings in property"

2. The exchange of property presents particular issues in applying the requirement of realization. The pertinent Treasury Regulation provides that an exchange of property is a realization event if it involves "property *differing materially* either in kind or in extent." Treas. Reg. § 1.1001-1(a) (emphasis added), *reprinted at* Pet. App. 65a. This expression of the realization requirement in exchanges of property is longstanding and consistent; it was first articulated in a Treasury Regulation in 1935 (Treas. Reg. 86, Art. 111-1 (1934 Revenue Act)), and has been in the Treasury Regulations ever since.

In accordance with this longstanding regulation, courts have regularly applied the "materially different" standard in determining whether an exchange of property is a taxable event. For example, in *Mutual Loan & Savings Co.* v. *Commissioner*, 184 F.2d 161 (5th Cir. 1950), in which the taxpayer surrendered defaulted municipal bonds in exchange for new refunding bonds with different terms, the Fifth Circuit held that the taxpayer did not realize a gain, under the pertinent Code provisions and Treasury Regulation (*id.* at 162), because the transaction did not constitute "the exchange of property for other property differing materially either in kind or in extent." *Id.* at 165. Other courts have also applied this standard. See, *e.g.*, *Emery* v. *Commissioner*, 166 F.2d 27, 29-30 (2d Cir. 1948) (taxable exchange); *City Bank Farmers Trust Co.* v. *Hoey*, 52 F.Supp. 665 (S.D.N.Y. 1942) (no taxable exchange), aff'd, 138 F.2d 1023 (2d Cir. 1943); *West Missouri Power Co.* v. *Commissioner*, 18 T.C. 105, 109-111 (1952) (no taxable exchange). See also Winterer, *"Reissuance" and Deemed Exchanges Generally*, 37 Tax Law. 509, 512 (1984) ("[W]hen an actual exchange occurs, gain or loss is not recognized unless the new property differs 'materially either in kind or in extent.' "); R. Magill, *Taxable Income*

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were includible in income, and that specified "losses" were deductible. Revenue Act of 1921, ch. 136, §§ 213(a), 214(a)(4), 42 Stat. 237, 239; Revenue Act of 1918, ch. 18, §§ 213(a), 214(a)(4), 40 Stat. 1065, 1066; cf. Revenue Act of 1916, ch. 463, §§ 2(a), 5(a), 12(a), 39 Stat. 757, 759, 767; Income Tax Act of 1913, ch. 16, §§ II B, G(a) and (b), 38 Stat. 114, 166.

143 (rev. ed. 1945) (Under the realization doctrine, gain or loss is "realized upon an exchange of property, if the property received differed materially in kind or extent from the property exchanged.").[10]

The reason for the requirement of a material difference is readily apparent. In the absence of such a requirement, the tax consequences of a disposition of property—a deduction in the case of a loss, income in the case of a gain—would apply even though the taxpayer's economic position remained essentially the same as if the taxpayer had not exchanged his property. In the case of an exchange of property which is *not* materially different, the taxpayer's economic position is essentially no different the day after the disposition from what it was the day before. By definition, an exchange of property involves property that the exchanging parties treat as having equivalent value; hence, if the exchanged properties are not materially different, the taxpayer has not changed his economic position.

Indeed, the requirement that exchanged property be materially different if an exchange is to constitute a realization event reflects a fundamental and venerable principle of taxation—that the substance rather than the form of a transaction determines its tax consequences. See, *e.g.*, *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334 (1945) ("The incidence of taxation depends upon the substance of a transaction."); *Gregory* v. *Helvering*, 293 U.S. 465, 469-470 (1935). This substance-over-form principle has been applied to determine whether a realization event has occurred. See, *e.g.*, *Shoenberg* v. *Commissioner*, 77 F.2d 446, 449 (8th Cir.), cert. denied, 296 U.S. 586 (1935); *Schonheit* v. *Lucas*, 44 F.2d 476, 479 (4th Cir. 1930); cf. *Mutual Loan*, 184 F.2d at 165 (examining "the realities of the situation"). See also Winterer, *supra*, 37 Tax Law. at 512 ("Except perhaps as camouflage, form counts for nothing; the ques-

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[10] Even before the Treasury Regulation, this Court concluded that an exchange resulted in taxable income only if the exchanged property had important differences from the received property. See *Marr* v. *United States*, 268 U.S. 536, 541 (1925); *Weiss* v. *Stearn*, 265 U.S. 242, 254 (1924).

tion in either case is whether the changes in the terms of the instrument are material.")[11]

3. The principle that exchanged property must be materially different in order to produce a realization event has been recognized by two of the three courts of appeals that have considered the tax consequences of R-49 mortgage swaps. See Pet. App. 8a; *Federal National Mortgage Ass'n* v. *Commissioner*, 896 F.2d 580, 583 (D.C. Cir. 1990), petition for cert. pending, No. 89-1987. The Sixth Circuit, however, held that there is no "materially different" requirement for realization in an exchange of property (*Cottage Savings Ass'n* v. *Commissioner*, 890 F.2d 848, 852 (6th Cir. 1989), cert. granted, No. 89-1965 (Oct. 1, 1990)); it went on to hold that the claimed losses were not deductible under Section 165 because the transactions lacked economic substance (*id.* at 853-855). Cf. note 11, *supra*. We agree with the Sixth Circuit's ultimate conclusion that the mortgage swaps did not produce deductible losses, but we do not agree with its determination that there is no "materially different" requirement for realization in an exchange of property.

The Sixth Circuit relied on Section 1001 (c). That Section provides: "Except as otherwise provided in this subtitle [Subtitle A of the Code, Sections 1-1564], the entire amount of the gain or

[11] As noted, the realization principle is founded, in part, on Section 165(a), which allows a deduction for a "loss sustained during the taxable year." The principle that the substance rather than the form of a transaction determines its tax consequences is regularly applied under Section 165 – losses from transactions that lack economic substance are not deductible under that Section. See, *e.g.*, *Higgins* v. *Smith*, 308 U.S. 473, 476-478 (1940) (applying principle to predecessor of Section 165); *Keats* v. *United States*, 865 F.2d 86, 88 (6th Cir. 1988); *Scully* v. *United States*, 840 F.2d 478, 484-486 (7th Cir. 1988); *Fender* v. *United States*, 577 F.2d 934, 936 (5th Cir. 1978). See also Treas. Reg. § 1.165-1(b) ("Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.").

Section 165 and Section 1001(a) are related in that there would be no purpose for Section 1001(a) to provide rules for determining the amount of a loss if Section 165 did not allow a deduction for that loss. Thus, the principle that purported losses from transactions lacking economic substance are not deductible under Section 165 can be viewed as simply another way of saying that no loss is "realized" on such transactions.

loss, determined under this section, on the sale or exchange of property shall be recognized." The Sixth Circuit concluded that Section 1001(c) means that gain or loss must be recognized on any sale or exchange of property, unless one of the Code's specific nonrecognition provisions applies. This construction of Section 1001(c), however, ignores the phrase "determined under this section," which means that a loss must first be "realized" for purposes of Section 1001(a) before it is "recognized" under the general rule of recognition stated in Section 1001(c). Accordingly, Section 1001(c) in no way supports the Sixth Circuit's conclusion that every exchange of property, including an exchange of property that is not materially different, is a realization event.[12]

In sum, the court of appeals below correctly held that a taxpayer realizes a loss on an exchange of property only if the property transferred is materially different from the property received. The question whether an exchange of mortgage loans that satisfy the Memorandum R-49 criteria results in the realization of a deductible loss turns, therefore, on the application of this "materially different" standard.

B. The Mortgage Loans Exchanged By Respondent Were Not Materially Different

A material difference is a difference that has the capacity to affect a decision. This definition accords with common usage, as evidenced by definitions of "material" in both ordinary and legal dictionaries.[13] It also accords with the meaning given

[12] To the extent that the Sixth Circuit's premise that there is no "materially different" realization requirement in property exchanges is accepted – which, in our view, would be a serious misinterpretation of the Code – we agree that the deductions nevertheless should be disallowed because the transactions lacked economic substance and thus did not produce losses deductible under Section 165. See note 11, *supra*.

[13] See, *e.g.*, *Webster's Third New International Dictionary* 1392 (1986) ("being of real importance or great consequence"); *The Random House Dictionary of the English Language* 1185 (2d ed. 1987) ("of substantial import; of much consequence; important • • • pertinent or essential • • • *Law*. likely to influence the determination of a case: *material evidence*."); *Black's Law Dictionary* 880 (5th ed. 1979) ("Important; more or less necessary; having in-

"material" in a variety of legal contexts.[14] In this particular context, the evidence of whether such differences as there were in the mortgage pools were material is available from three different sources: (1) the conduct and intent of the parties; (2) the evaluation of the pertinent market (the secondary mortgage market); and (3) the determination of the administrative entity charged with regulating and overseeing the operations of federal savings and loan associations. Each of these sources provides strong evidence that the differences in the exchanged mortgage pools were not "material."[15]

Before considering each of these sources, it is useful to focus briefly on the criteria of Memorandum R-49 and the context of the secondary mortgage market. A mortgage loan, like other types of debts, represents a right to receive payments over time. If two mortgage loans (or two groups of loans) have the same principal, interest rate, and maturity date, then payment according to their terms will result in identical income streams.

fluence or effect; going to the merits; having to do with matter, as distinguished from form. Representation relating to matter which is so substantial and important as to influence party to whom made is 'material.' ").

[14] See, *e.g.*, *Kungys* v. *United States*, 485 U.S. 759, 770-771 (1988) (in criminal law and naturalization contexts, "a concealment or misrepresentation is material if it 'has a natural tendency to influence, or was capable of influencing, the decision of' the decisionmaking body to which it was addressed"); *Basic, Inc.* v. *Levinson*, 485 U.S. 224, 240 (1988) (in securities law context, "materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information"); *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976) (in proxy-solicitation context, "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote"). Cf. *Black's Law Dictionary* at 881 ("Material fact. *Contracts*. One which constitutes substantially the consideration of the contract, or without which it would not have been made."); *ibid.* ("Material fact. • • • *Insurance*. A fact which, if communicated to the agent or insurer, would induce him either to decline the insurance altogether, or not accept it unless a higher premium is paid. • • • Any fact the knowledge or ignorance of which would naturally influence the insurer in making or refusing the contract, or in estimating the degree and character of the risk, or in fixing the rate.").

[15] We do not dispute that the exchanged mortgages were "different." The pertinent question is whether they were *materially* different.

But, of course, not all mortgage loans are paid according to their terms. A debtor may prepay the loan, make late payments, or stop making payments altogether, resulting in foreclosure. The critical question in evaluating two loans with the same terms is thus the risk of these events, *i.e.*, the nature of potential future performance; actual future performance is unknown and unknowable.

The very purpose of Memorandum R-49 was to set forth criteria that, if satisfied, would mean that two different mortgage loans (or groups of loans) would have the same risk. The Bank Board unit that promulgated Memorandum R-49, the OES, stated that mortgage loans involve three types of risks, related to "credit (collectibility), rate (future earnings potential), and repayment (extent of principal repayments and prepayments)." J.A. 58. Where all ten criteria of Memorandum R-49 are satisfied, however, "risk does not transfer" (J.A. 59); the risks inherent in the two loans are the same. Therefore, in the view of the OES, an exchange of the loans does "not change the economic position of the [savings] association after it engaged in the swap." J.A. 58. In the words of the Bank Board, the exchanged loans are "substantially identical" as economic assets. J.A. 55.

1. With regard to the conduct and intent of the parties, it is clear that the differences in the mortgage loans were not material; the differences did not make a difference. The court of appeals relied on two differences in the exchanged mortgages—that they involved different borrowers and different collateral. See *San Antonio*, 887 F.2d at 589 ("[D]ifferent obligors and collateral result in mortgage participation interests which are materially different.") But respondent was plainly unconcerned with these differences; it conducted no credit checks on the borrowers or appraisals of the collateral. Pet. App. 36a, 52a.[16] Indeed, the selection of particular loans for inclusion in

[16] The taxpayers in the other cases involving Memorandum R-49 mortgage exchanges likewise did not investigate the borrowers or collateral of the loans they received in the exchanges. See *Cottage*, 890 F.2d at 849; *San Antonio Savings Ass'n* v. *Commissioner*, 55 T.C.M. (CCH) 813, 814 (1988) (facts

an exchange was performed entirely by a computer that was programmed to match mortgages in accordance with the R-49 criteria. *Id.* at 35a-36a. Respondent did not even know or care to know the identities of the individual borrowers. The closing schedules attached to the agreements under which the loans were transferred listed the addresses of the underlying properties but not the names of the borrowers. PXs 3-6. It was not until 1987—six years after the exchange—that respondent received files on the loans it acquired. Pet. App. 36a n. 5. Respondent made no attempt whatsoever to evaluate the risk factor of individual loans.[17] The failure to conduct any investigation to evaluate the risks indicates that respondent was wholly unconcerned with any possible variance in risk between the loans it was transferring and the loans it was receiving—*i.e.*, that respondent was satisfied that the effect of applying the R-49 criteria was to render any such variance immaterial.

The manner in which respondent and FNMA valued the loans they were exchanging further demonstrates that the parties viewed individual differences between the loans as immaterial. Obviously, to the extent an individual loan in the exchanged mortgage pools was riskier than the others, it was correspondingly less valuable (since the terms of the loans in the Memorandum R-49 transactions were identical). Yet respondent and FNMA did not draw distinctions among individual loans in valuing them. The parties applied one common discount factor to each side of the transaction on all the conventional loans and another discount factor on all the FHA/VA loans (Pet. App. 36a), thereby indicating that they could discern no difference in the overall risk of the loans involved in the exchange. The parties' valuation of the loans could indicate one of several things: (1) the parties viewed each loan as being equally risky; (2) the

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essentially the same as facts in *Cottage*), aff'd, 887 F.2d 577 (5th Cir. 1989), petition for cert. pending, No. 89-1928; *First Federal Savings & Loan Ass'n* v. *United States*, 694 F.Supp. 230, 235 (W.D. Tex. 1988), aff'd, 887 F.2d 593 (5th Cir. 1989), petition for cert. pending, No. 89-1927; *Federal National Mortgage Ass'n* v. *Commissioner*, 90 T.C. 405, 412 (1988), aff'd, 896 F.2d 580 (D.C. Cir. 1990), petition for cert. pending, No. 89-1987.

[17] While respondent claimed awareness of some differences in the general characteristics of the loan packages, the district court specifically concluded that those claimed general differences were immaterial. Pet. App. 39a, 52a.

parties recognized that there might be disparities in the relative risk of similar loans, but they could not tell which loans were riskier, and thus could not take the differences into account in the terms of the exchange; or (3) given the large number of loans contained in each pool, risk differences in individual loans were statistically insignificant and did not alter the fact that each pool of loans was an equally risky investment (see *First Federal Savings & Loan Ass'n* v. *United States*, 694 F. Supp. 230, 245 n. 15 (W.D. Tex. 1988), aff'd, 887 F. 2d 593 (5th Cir. 1989), petition for cert. pending, No. 89-1927). Whichever the reason, it is clear that the differences in the identity of the borrower and the particular property securing the loan simply did not matter to the parties involved in the transaction. This being the case, the differences, by definition, were not material to the parties.

The court of appeals objected to the Commissioner's reliance on the parties' conduct and intent concerning the exchange. According to the court, the parties' actions are irrelevant in determining materiality because "[i]t must be the objective and not subjective factors, * * * which determine whether a realization event occurred. Otherwise the Code could not be fairly applied to disparate individuals." *San Antonio*, 887 F.2d at 590. The court's wholesale rejection of this evidence, however, misses the point. The conduct and intent of the parties, as economic actors, are probative of the nature of the *transaction*, including the materiality of the claimed differences. To assume otherwise is to reject a category of extremely informative evidence concerning the substance of the exchange. The conduct and intent of the parties are not the only consideration in evaluating whether differences are material, but they are surely an appropriate—and highly pertinent—consideration.

2. The secondary mortgage market, which routinely deals with packages of residential mortgages, also regarded as immaterial the differences between individual loans in a Memorandum R-49 exchange. The district court in this case specifically found that "because information was not available at the time of the transaction regarding individual differences among the loans, the marketplace *was unable to and did not differentiate* between the pools." Pet. App. 52a (emphasis added). See also

id. at 52a-53a ("Lacking economic relevance, these differences were not materially distinguishable and were therefore irrelevant, especially to a secondary mortgage market dealing in pools of similarly seasoned mortgages."); *First Federal,* 694 F. Supp. at 245 ("loans meeting the criteria of Memorandum R-49 are considered economically indistinguishable" in the secondary mortgage market).

The court of appeals did not dispute that the secondary mortgage market considered the differences in the mortgage pools economically indistinguishable. Instead, it held that this fact was also irrelevant to the "materially different" inquiry. *San Antonio,* 887 F.2d at 589-590. The question whether one property is materially different from another property for which it is exchanged, however, has long included a consideration of how investors in general—*i.e.,* the marketplace—view the exchanged properties. See, *e.g., Emery* v. *Commissioner,* 166 F. 2d 27, 29 (2d Cir. 1948) (referring to how the "investing public" viewed the differences between bonds as part of determination that those differences were material); *Hanlin* v. *Commissioner,* 108 F. 2d 429, 430 (3d Cir. 1939) (securities are "substantially identical" for purposes of statutory wash sale rule under predecessor to I.R.C. § 1091 where "differentiations [are] so slight as to be unreflected in the acquisitive and proprietary habits of holders of stocks and securities"). Moreover, the court of appeals' rejection of a marketplace inquiry is difficult to square with its own statement that "fungible" goods are not materially different. See *San Antonio,* 887 F. 2d at 586. Items are "fungible" if the relevant market treats them as fungible—*i.e.,* if any differences between the items are viewed by the market as wholly inconsequential. Thus, the inquiry into whether goods are fungible (an inquiry the court of appeals viewed as permissible under Section 1001(a) (see 887 F. 2d at 583, 586)), may often require an inquiry into how the goods are viewed in the marketplace.[18]

[18] For example, if the differences between Kansas wheat and Nebraska wheat are deemed by the marketplace to be too insignificant to be taken into account, then these items by definition are fungible. If, however, Kansas wheat has some characteristic that distinguishes it in some notable way from Nebraska wheat (*e.g.,* it is more flavorful), then the items would not be fungible. Another example is Colombian coffee, which, because of its distinctive flavor and aroma, sells at a premium and is not fungible with coffee grown elsewhere.

By definition, an exchange of property involves property that the parties are willing to treat as having equivalent value, and presumably the market will often agree that the exchanged properties have equivalent value. The evaluation of the secondary mortgage market is nevertheless important to the "materially different" inquiry for a quite different reason—to determine whether differences in the exchanged properties had the capacity to affect the outcome of the transactions. And it is highly significant that, in the view of the secondary mortgage market, the differences in the individual loans in this exchange of mortgage pools did not affect their value and hence were not material.[19]

3. The conclusion that the exchanged loans were not "materially different" is strongly buttressed by the evaluation of the Bank Board. At the time, the Board was charged by Congress with, *inter alia,* providing rules and regulations for the "examination, operation, and regulation" of federal savings and loan associations. 12 U.S.C. 1464 (a) (1988), replaced by Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 301, 103 Stat. 282 (to be codified

[19] The court of appeals incorrectly suggested that the government's position is that two mortgage loans are not materially different "[j]ust because [they] are assigned the same value in the secondary mortgage marketplace." *San Antonio,* 887 F.2d at 589. That is not our position. A portfolio of stock and an automobile may have the same value, but they are still materially different. The court of appeals also invoked a hypothetical situation involving the bonds of two different companies, which have the same terms and the same value. *San Antonio,* 887 F.2d at 589-590. The two bonds in the court's hypothetical have the same value because the market evaluated the various differences between the two companies and the risks associated with those differences, and the resulting valuations happened to coincide. Those differences mattered to the market; they were taken into account in valuing the bonds. Here, by contrast, after two loans (or groups of loans) were matched according to the R-49 criteria, the remaining differences in the loans were not taken into account in valuing the loans, demonstrating that those differences were immaterial.

at 12 U.S.C. 1464). Accordingly, the Bank Board's determination that mortgage loans meeting the criteria of Memorandum R-49 are "substantially identical" is entitled to considerable respect (see, *e.g.*, *Ford Motor Credit Co.* v. *Milhollin*, 444 U.S. 555, 566 (1980)), and is, at the very least, highly probative evidence concerning the significance of the differences in the loans.

While acknowledging that its conclusion that "two items can at the same time be 'substantially identical' and 'materially different' seems illogical" (*San Antonio*, 887 F. 2d at 591), the court of appeals dismissed the Bank Board's opinion as having "no direct relevance" (*ibid.*), stating that " 'substantial identity' " is "a different concept for a different administrative purpose from the IRS's concept of 'material difference' for tax purposes" (Pet. App. 8a). In fact, however, the administrative purposes served by the "substantially identical" standard and the "materially different" standard are quite similar.

The purpose of Memorandum R-49, as stated by the Bank Board unit responsible for its promulgation, was to provide a blueprint for a transaction that would not "change the economic position" of the parties to the transaction. J.A. 58. This characterization was the cornerstone of Memorandum R-49 because a change in economic position would have required the parties to record their losses for financial and regulatory purposes—which the parties clearly wanted to avoid, because of the problem of satisfying the Bank Board's minimum net worth and liquidity standards. Indeed, were it not for the unwillingness of respondent and the other financial institutions involved in R-49 transactions to report this loss for financial and regulatory purposes, they could have obtained their desired tax losses simply by selling their depreciated mortgage loans for cash. The admitted purpose of the R-49 criteria was to assure that the swap transactions would not affect the economic position of the participants (and hence would not diminish their assets—*i.e.*, not constitute realization of a loss—for financial reporting and regulatory purposes).

The purpose of the "materially different" requirement for realization in Treas. Reg. § 1.1001-1(a) is the same: to ensure

that gain or loss is realized for tax purposes only if a taxpayer changes his economic position, *i.e.*, realizes a gain or loss in substance as well as in form.[20] Thus, the Bank Board's expert opinion that mortgages satisfying the Memorandum R-49 criteria are "substantially identical" is directly relevant to the tax question presented here. As the district court concluded in *First Federal* (694 F. Supp. at 245), "it becomes almost ludicrous to suggest that R-49 loans are at the same time 'substantially identical' for financial accounting purposes and 'materially different' for tax accounting purposes when the objective of both systems in this context is to accurately describe economic reality." Cf. *Portland Golf Club* v. *Commissioner*, 110 S. Ct. 2780, 2789 (1990) (rejecting taxpayer's claim as resting on an "inherent contradiction").

It is the Bank Board's determination that mortgage loans meeting the R-49 criteria are "substantially identical" that is significant here, not its conclusion that no loss on a R-49 transaction need be reported for financial or regulatory purposes. An exchange of loans that are "substantially identical" does not result in realization of a loss for tax purposes, regardless of how the Bank Board chose to treat that exchange for regulatory accounting purposes.[21] Accordingly, the observation of the court of appeals (*San Antonio*, 887 F. 2d at 591; see Pet. App. 8a) that the accounting requirements of regulatory agencies are not controlling in the application of the tax laws is beside the point.

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[20] Cf. *Shoenberg*, 77 F.2d at 449 (where a sale of property "is made as part of a plan whereby substantially identical property is to be reacquired * * * the taxpayer has not actually changed his position"); *Hanlin*, 108 F.2d at 430 (wash sales of "substantially identical" property described as resulting in "the lack of any change in economic position on the part of the taxpayer").

[21] The Bank Board unit that promulgated Memorandum R-49 was of the opinion that loans that complied with Memorandum R-49 still could be viewed as "materially different" for tax law purposes. *San Antonio*, 887 F.2d at 580; J.A. 58. Since it is the Internal Revenue Service, not the Bank Board, that is charged with administering the tax laws, the Bank Board's view of this tax question is entitled to no deference. See *United States* v. *Stewart*, 311 U.S. 60, 70 (1940); *Graff* v. *Commissioner*, 673 F.2d 784, 786 (5th Cir. 1982) (Brown, J., concurring). The Commissioner's position that the swap of substantially identical mortgage pools does not satisfy the "materially different" requirement is reflected in two Revenue Rulings. See Rev. Rul. 85-125, 1985-2 C.B. 180; Rev. Rul. 81-204, 81-2 C.B. 157.

We do *not* contend that respondent's loss was not allowable for tax purposes merely because the Bank Board had determined that respondent incurred no loss for financial accounting purposes. The Bank Board's underlying expert conclusion, however, that mortgage loans meeting the R-49 criteria are "substantially identical," and therefore that an exchange of such loans produces no change in the economic position of the participants, goes to the heart of the "materially different" requirement in the Treasury Regulations. Thus, contrary to the decision of the court of appeals, this conclusion is highly relevant to the subject tax controversy. Like the conduct of the parties and the evaluation of the secondary mortgage market, the determination of the Bank Board that satisfaction of the R-49 criteria renders loans "substantially identical" establishes that any differences in the individual loans were not "material."

4. Having rejected the relevance of (1) the conduct and intent of the parties, (2) the evaluation of the secondary mortgage market, and (3) the determination of the Bank Board concerning the substantial identity of the loans, the court of appeals relied instead on its own conclusion that differences in borrowers and collateral always produce material differences. *San Antonio,* 887 F.2d at 591; Pet. App. 8a-9a. We submit that the court's rule is far too sweeping, fails to take into account differences in contexts and transactions, and is completely unsupported by the record in this case. Differences in borrowers and collateral *may* represent material differences, but they may not. The proof is in the pudding. Here, whether consideration is given to the parties, the market, or the Board, the differences were in fact viewed as incidental, rather than material. The court of appeals was able to reach its conclusion only by rejecting the relevance of each of those sources of evidence.

Two other aspects of the court of appeals' analysis warrant mention. First, in both this case and *San Antonio,* as part of its emphasis on differences in the collateral, the court of appeals mentioned geographic differences in the exchanged mortgages. See Pet. App. 8a; *San Antonio,* 887 F.2d at 588. Again, however, there is no indication that, with respect to these mortgage loan pools, such differences were given significance by the parties, the secondary mortgage market, or the Bank Board. To the contrary, the R-49 criteria explicitly include a geographic criterion as one of the ten requirements for "substantially identical" loans—the loans must "have all security properties for both sides of the transaction in the same state." J.A. 56 (requirement 10). Thus, the court of appeals' reference to geographic differences has the point exactly backwards; to the extent that geographic characteristics were relevant to the transactions, it was to ensure substantial identity, not to reflect differences.[22]

Second, the court of appeals also stated that the subsequent history of the exchanged mortgage loans established that the loans were materially different because that history revealed different loan performances. Pet. App. 8a; *San Antonio,* 887 F. 2d at 591. This *post hoc* reasoning is misconceived. The question whether the mortgage loans were materially different turns on the significance of whatever differences were known at the time of the exchange. Given that the parties, the secondary mortgage market, and the Bank Board did not evaluate then-existing differences in the loan package as material, the fact that some loans turned out to be better than others is entirely beside the point.[23]

[22] The court of appeals also noted (887 F.2d at 587-589) the decision in *Hanlin,* in which the Third Circuit concluded, for purposes of a specific "wash sale" statute (the predecessor of I.R.C. § 1091), that bonds of the St. Louis, Wichita, and Louisville Federal Land Banks were not "substantially identical" because the bonds were secured by different collateral with "substantial variance in agricultural and financial resources" in the three areas, such as differences in "the type (and marketability) of crops produced—or, perhaps, the likelihood of dust storms." 108 F.2d at 431. Unlike the court of appeals' decision in this case, *Hanlin* did not purport to establish a rule that different collateral always gives rise to a material difference. To the contrary, *Hanlin* defined the importance of differences with reference to "the acquisitive and proprietary habits of holders of stocks and securities" (108 F.2d at 430)—a market-based inquiry effectively rejected by the court of appeals here. Moreover, *Hanlin* did not address a situation in which geographic diversity was limited to the same State specifically to ensure substantial identity in the loans.

[23] The court of appeals also observed that "[t]he average net worth of the mortgagors in the mortgages received was 40% higher than in the mortgages traded off." Pet. App. 8a. This difference is an aspect of the court's emphasis on the difference in borrowers and partially reflects a difference in the total number and average value of mortgages in the two packages (see Pet. App. 34a); the particular difference cited by the court was not material in the evaluation of the parties, the market, or the Board.

In sum, in concluding that the differences in the obligors and the collateral rendered the exchanged mortgage loans "materially different," the court of appeals, without any basis in the record, substituted its evaluation of the significance of those differences for that of the participants to the transactions, the market in which the transactions took place, and the administrative entity charged with regulating federal savings and loan institutions. On the undisputed facts here, the court was compelled to conclude that the exchanged loans were not materially different and that for that reason no loss was realized by respondent on the exchange.

II. INCOME RECEIVED BY RESPONDENT FROM ITS DEPOSITORS AS PENALTIES FOR EARLY WITHDRAWAL OF THEIR FUNDS WAS NOT EXCLUDABLE FROM GROSS INCOME AS INCOME FROM THE DISCHARGE OF INDEBTEDNESS UNDER SECTION 108

Respondent's receipt of penalties for early withdrawals from certificates of deposit should not be excluded from its income for two reasons: (1) the exclusion from income provided by Section 108 does not apply to terminations of indebtedness that are actually methods of payment for separate obligations, and (2) respondent's receipt of those penalties represents such a method of payment for a separate obligation. Here, too, although the court of appeals agreed with the first proposition, it erred in its analysis of the second.

A. Section 108's Exclusion From Income Is Limited To Income From The Discharge Of Indebtedness

1. Section 61(a) of the Internal Revenue Code provides that, except as otherwise provided in the Code, gross income means "all income from whatever source derived." Accordingly, any funds or other accessions to wealth received by a taxpayer are presumed to be gross income, unless the taxpayer can demonstrate that the accession fits into one of the specific exclusions created by other sections of the Code. *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 430-431 (1955).

2. The exclusion at issue here is found in Section 108 of the Code. That Section provides, in pertinent part, that gross income does not include any amount that would be "includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer" if the indebtedness is "qualified business indebtedness." I.R.C. § 108(a)(1)(C). "Qualified business indebtedness," in turn, is defined to include indebtedness incurred by a corporation. I.R.C. § 108(d)(4). In order to qualify for the exclusion, the taxpayer must make an election to reduce its basis in depreciable property it owns in an amount equal to the amount excluded from gross income under Section 108. See I.R.C. §§ 108(c), 108(d)(4)(B), 1017. The effect of these provisions is to defer the tax on the debt discharge income; the tax is ultimately collected indirectly because the taxpayer must take lower depreciation deductions for the reduced-basis assets or recognize greater gains on their sale. See S. Rep. No. 1035, 96th Cong., 2d Sess. 8-9 (1980).

The principle that a taxpayer may realize income from the discharge of indebtedness was established in *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931).[24] The predecessor of Sec-

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[24] This principle is now codified in Section 61(a)(12), which provides that gross income includes "[i]ncome from discharge of indebtedness." The treatment of discharge of indebtedness as income has been justified by two different theories—an obligation-to-repay theory and a freeing-of-assets theory. Under the obligation-to-repay theory, when a taxpayer discharges his indebtedness at less than the amount of the loan, he has received some loan proceeds that he has not been required to repay, and thus has realized taxable income. (In the absence of discharge of indebtedness, loan proceeds do not qualify as income to the taxpayer because he acknowledges an obligation to repay them). See *Commissioner* v. *Tufts*, 461 U.S. 300, 307 (1983) (explaining obligation-to-repay theory in context of nonrecourse mortgage loan); *id.* at 310-311 n.11 (noting that, "[i]n one view," theory applies to cancellation of indebtedness as well). *Kirby Lumber* itself suggested a freeing-of-assets theory—that the cancellation of indebtedness produces taxable income because it frees assets. 284 U.S. at 2. Cf. *Commissioner* v. *Tufts*, 461 U.S. at 310-311 n.11 (noting freeing-of-assets theory). This freeing-of-assets theory has been criticized as less sound than the obligation-to-repay theory. See Bittker & Thompson, *Income From the Discharge of Indebtedness: The Progeny of United States* v. *Kirby Lumber Co.*, 66 Calif. L. Rev. 1159, 1165-1166 (1978).

tion 108 was enacted to provide relief from the *Kirby Lumber* principle for certain categories of debtors. Section 22(b)(9) of the Internal Revenue Code of 1939 (26 U.S.C. (1940)), as enacted by Section 215(a), Revenue Act of 1939, ch. 247, 53 Stat. 875, provided that a corporation "in an unsound financial condition" could exclude the amount of any income "attributable to the discharge • • • of any indebtedness • • • evidenced by a security," if the corporation elected to reduce its basis in property under Section 113(b)(3) of the 1939 Code (the predecessor of Section 1017). In 1942, Congress broadened the reach of this section by removing the requirement that the corporation be in an "unsound financial condition." See Section 114(a) of the Revenue Act of 1942, ch. 619, 56 Stat. 811. The general purpose of the provision was to facilitate a corporation's ability to strengthen its financial position through retirement of outstanding debt—by allowing deferral of the tax on the resulting debt discharge income (which ordinarily would not produce cash or other assets that could be used to pay the tax).[25] This provision was reenacted as Section 108 of the 1954 Code, with some modifications that are not material here. See H. R. Rep. No. 1337, 83d Cong., 2d Sess. 13 (1954). Congress further revised Section 108 in 1980,[26] and the provision enacted in 1980 governs this case. Although the 1980 revision made some significant changes in Section 108, those changes do not bear on the

[25] The House Report on the 1939 legislation stated as its purpose to aid corporations "whose bonds can be purchased at the present time at less than their face value, giving them an incentive to liquidate their indebtedness." H.R. Rep. No. 855, 76th Cong., 1st Sess. 5 (1939). The Senate Report on the 1942 amendment explained that Congress had determined that limiting the availability of deferral to companies willing to declare their "unsound financial condition" had the effect of "deny[ing] the benefits of this section in many meritorious cases," and stated that removing that restriction "makes it possible for all corporations to have the advantages granted by this section without an impairment of their credit." S. Rep. No. 1631, 77th Cong., 2d Sess. 46, 78 (1942). See also 97 Cong. Rec. 3796 (1951) (statement of Rep. Camp) (provision "removes an impediment to strengthening the financial position of a corporation through debt reduction"). See generally Wright, *Realization of Income Through Cancellations, Modifications, and Bargain Purchases of Indebtedness*, 49 Mich. L. Rev. 459, 492 (1951).

[26] Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 2(a), 94 Stat. 3389.

issue in this case. See generally S. Rep. No. 1035, 96th Cong., 2d Sess. 2-4, 8-23 (1980) (explaining changes).[27]

3. Not every debt that is cancelled or discharged results in income "by reason of the discharge • • • of indebtedness" within the meaning of Section 108. If the cancellation of a debt is not the source of the income, but simply the method by which a creditor makes a payment to a debtor, then the debtor does not have income "by reason of" a debt discharge, and the Section 108 exclusion does not apply. See S. Rep. No. 1035, 96th Cong., 2d Sess. 8 n. 6 (1980) ("Debt discharge that is only a medium for some other form of payment such as a gift or salary, is treated as that form of payment rather than under the debt discharge rules."); *Colonial Savings Ass'n* v. *Commissioner*, 854 F.2d 1001, 1005 (7th Cir. 1988) ("[W]hen the discharge of indebtedness is a mere medium for the payment of a separate obligation between two parties, section 108 does not apply."), cert denied, 109 S. Ct. 1556 (1989); *OKC Corp.* v. *Commissioner*, 82 T.C. 638, 649 (1984) ("[S]ection 108 • • • does not apply if the debt forgiveness is simply the method by which a creditor makes a payment to a debtor."); *Spartan Petroleum Co.* v. *United States*, 437 F. Supp. 733, 736-737 (D.S.C. 1977); Bittker & Lokken, *supra*, ¶ 6.4.4, at 6-49; Bittker & Thompson, *Income From the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber Co.*, 66 Calif. L. Rev. 1159, 1174, 1186 (1978).

The court of appeals in this case agreed with this general principle. See Pet. App. 17a ("In cases of spurious debt discharge, the debt discharge is often described as merely the 'medium of

[27] In 1986, after the tax year at issue here, Congress came full circle and amended Section 108 to provide that, for transactions occurring after 1986, the exclusion is available only where the discharge of indebtedness occurs in a bankruptcy case or when the taxpayer is insolvent. Tax Reform Act of 1986, Pub. L. No. 99-514, § 822(a), 100 Stat. 2085, codified at 26 U.S.C. 108. The Senate Report explained that allowing the exclusion in all situations in which corporate or other business indebtedness was discharged was "too generous" because "[i]ncome from such discharges generally is deferred by reducing the basis of depreciable assets, regardless of the capacity of the taxpayer to currently pay the tax." S. Rep. No. 313, 99th Cong., 2d Sess. 161 (1986).

payment' for an obviously separate obligation between two parties."); *id.* at 18a ("[O]nly genuine or 'pure' debt discharge income falls within the ambit of § 108."). In conflict with the Seventh Circuit and Tax Court decisions in *Colonial Savings*, however, the court concluded that a depositor's early withdrawal penalty is not a "separate obligation," and that the penalty represented "income from the discharge of indebtedness" for purposes of Section 108. Pet. App. 19a, 28a. The court's application of the general principle is incorrect.

B. Respondent Did Not Receive Income "By Reason Of The Discharge * * * Of Indebtedness"

1. During 1981, respondent offered certificate of deposit savings accounts with various fixed terms. A depositor was permitted to withdraw the principal from one of these accounts prior to maturity, but federal regulations required the depositor to pay a penalty in the event of such early withdrawal. See 12 C.F.R. 1204.103 (1981); 12 C.F.R. 526.7 (1980); 12 C.F.R. 526.7 (1979).[28] The amount of the minimum penalty, which was generally equal to the interest earned on the account for a certain period, was prescribed by the same regulations. The regulations did not specify the method of payment. Under the terms of respondent's certificates, the depositor received a single net amount from respondent, consisting of the principal on deposit plus interest payable to the date of withdrawal, less the penalty. Pet. App. 11a & n.4, 54a-55a; J.A. 27-29.

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[28] The district court referred (Pet. App. 55a) only to 12 C.F.R. 1204.103 (1981). Since that regulation applied only to accounts opened or renewed after June 1, 1980 (see 45 Fed. Reg. 37,801, 40,109 (1980)), it is likely that some of the penalties in issue were governed by 12 C.F.R. 526.7 (1979), which applied to accounts opened before July 1, 1979, and 12 C.F.R. 526.7 (1980), which applied to accounts opened after June 30, 1979, but before June 2, 1980. The two earlier versions of the regulation were promulgated by the Federal Home Loan Bank Board. See 44 Fed. Reg. 46,441, 46,442 (1979); 43 Fed. Reg. 46,835, 46,845 (1978). The later version of the regulation was promulgated by the Depository Institutions Deregulation Committee. See 45 Fed. Reg. 37,801, 40,109 (1980). The differences in the three versions of the regulation related mainly to the amount of the penalty.

2. Respondent did not have income "by reason of" the discharge of indebtedness; it had income "by reason of" receiving a penalty. Income from the discharge of indebtedness is realized where a debt is discharged for less than its face amount, *i.e.*, where all or a portion of the debt is forgiven. Here, although the debt owed to a depositor was "discharged" in the sense that it was extinguished, it was not discharged for less than face value. The portion of the debt that respondent did not pay to the depositor was not forgiven by the depositor, but rather was used to satisfy—*i.e.*, to pay—the penalty obligation owed by the depositor. Since the reduction in the debt was merely a method of payment for the penalty (by means of offset), respondent did not have income "by reason of the discharge" of indebtedness.

Indeed, consistent with the regulations, respondent could have chosen to provide that the penalty would be paid in cash by the depositor. If the depositor had paid the penalty due respondent in cash, and, in turn, received from respondent the entire amount due on the account, then respondent would have had income in the amount of the penalty. That income, however, clearly would not have been income from the discharge of indebtedness because there would be no discharge of a debt for less than its face amount; the source of the income simply was the receipt of the penalty. The result should be no different where, as here, the method of paying the penalty was to reduce the amount turned over to the depositor. In effect, respondent simply offset the amount of the penalty the depositor owed respondent against the amount that respondent owed the depositor, but that method of payment does not change the nature of the payment.[29]

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[29] Although the court of appeals' opinion is not entirely clear on this point, the court apparently concluded that, even if the depositors had paid their penalties in cash, respondent's receipt of these penalties should be characterized as income from discharge of indebtedness. See Pet. App. 22a-23a. But cf. Pet. App. 11a n.4 (emphasizing that "technically no CD holders ever *paid* a 'penalty' to Centennial – they merely received less money than they would have received if the accrued interest had been paid and the penalty had not been assessed").

In concluding that the early withdrawal penalty was not a separate obligation, the court of appeals fundamentally misapprehended the nature and purpose of the penalty. The penalty is imposed from outside the debtor/creditor relationship, by federal law, for general federal regulatory purposes. The purpose of the government requirement was to deter early withdrawals; the regulatory decision to impose the requirement was based on a policy determination about the need for such a deterrent. See 45 Fed. Reg. 37,802 (1980) ("This action was taken by the Committee in view of the increased number of early withdrawals of time deposits that have occurred and the adverse effects of such withdrawals on the costs of depository institutions and on their ability effectively to manage their liabilities."); 44 Fed. Reg. 33,672 (1979) (penalty is a "disincentive to early withdrawal" and "effectively inhibits disintermediation"). See also *Colonial*, 854 F. 2d at 1006 (emphasizing that the regulations "impose these penalties to ensure the systemic health of the nation's banking institutions").[30] The court of appeals here dismissed the fact that the penalty is imposed as an aspect of governmental regulatory policy as inconsequential. Pet. App. 20a. Surely, however, that fact is of significance to whether the early withdrawal penalty represents a separate obligation or simply the debtor's discharge of indebtedness. Contrary to the Fifth Circuit's statement (*id.* at 23a), the penalty was not "bargained for as an integral part of the single transaction"; rather, the penalty was imposed from outside the parties' debtor/creditor relationship by federal regulations.

Furthermore, even viewed solely within the context of individual creditor/debtor relationships and without reference to the governmental role in imposing the penalties, early withdrawal penalties do not produce income "by reason of the discharge * * * of indebtedness." I.R.C. § 108(a)(1). The role of the penalty is not to forgive or cancel some of the debt itself as a

[30] Cf. 48 Fed. Reg. 38,456 (1983) (penalty is "desirable to protect depository institutions that invest in long-term assets on the planning presumption that the deposits will be maintained until maturity").

method of resolving the indebtedness; instead, the role is to compensate the bank for any resulting expenses. As the Seventh Circuit explained, the payment "is to compensate the bank-debtor for the harm done by the depositor's change in position. It is a form of liquidated damages for the added expense that the bank must suffer in an effort to procure the funds that have been lost." *Colonial*, 854 F. 2d at 1007. As a result, the penalty serves a different function from the discharge of indebtedness and represents a separate obligation; the method of payment for that separate obligation does not result in income from the discharge of indebtedness within the meaning of Section 108.[31]

3. The conclusion that early withdrawal penalties represent a separate obligation from the debt owed to depositors is further buttressed by the Commissioner's analysis of the tax consequences for the depositor and by Congress's reaction to that

[31] The court of appeals also observed that "[n]o separate contract created the CD [certificate of deposit] penalty." Pet. App. 20a. But the fact that there was but one *contract* between respondent and a depositor does not mean that there was only one *obligation* involving respondent and that depositor. Respondent's obligation to its depositor when he redeemed a savings certificate was typical of the traditional relationship between a debtor-bank and a creditor-customer. The penalty was a distinct obligation owed to respondent by the depositor once he elected to make an early withdrawal. The depositor's obligation to pay the penalty thus was a separate aspect of the parties' relationship.

Additionally, the court of appeals emphasized that, in other cases in which cancellation of a debt merely was the method by which the creditor made a payment to the debtor, the two obligations that were offset were unrelated and the payment the creditor was obligated to make to the debtor was not part of the debtor-creditor relationship. Pet. App. 17a-18a, 21a-22a, citing *OKC Corp., supra; Spartan Petroleum, supra.* But nothing in those cases, or in the rationale behind the "method of payment" principle, suggests that that principle applies only where the separate obligation is completely unrelated to the debtor-creditor relationship. The controlling question is whether the taxpayer's income derives from the debt discharge itself or from the payment of a separate obligation. That the existence of this separate (albeit contingent) obligation was recognized by the parties from the outset, as a part of the transaction to which they agreed, serves more to corroborate, than to undermine, the conclusion that its payment did not constitute forgiveness or revision (and hence not income by reason of discharge) of the debt.

analysis. In Rev. Rul. 73-511, 1973-2 C.B. 402, the Commissioner ruled that a depositor who pays an early withdrawal penalty out of interest earned on the account may not reduce his interest income by the amount of the penalty, but rather must report the full amount of interest earned on the account; he may then deduct the amount of the penalty as a loss under Section 165 of the Code. The ruling was based on the determination that the interest and the penalty represent separate transactions. See 1973-2 C.B. at 403 ("[T]he interest paid or credited and the forfeiture incurred represent two separate transactions and are taxable as such."). The ruling further concluded that the loss would, in the case of an individual depositor, generally be considered as a loss "incurred in any transaction entered into for profit, though not connected to a trade or business," as described in Section 165(c)(2). One of the consequences of this determination was that the loss could be claimed as a deduction only by a taxpayer who itemizes deductions. See I.R.C. § 63.

Congress was troubled by the proposition that taxpayers who used the standard deduction could not deduct their early withdrawal penalties. Accordingly, it amended the Code to provide that the deduction for early withdrawal penalties would be allowable in arriving at adjusted gross income, thus allowing non-itemizers to claim the deduction as well. See Act of Oct. 26, 1974, Pub. L. No. 93-483, § 6 (a), 88 Stat. 1457 (current version codified at 26 U.S.C. 62(a)(9) (1988)). Although the legislation is explicitly based on a reaction to the Revenue Ruling, nothing in the legislation or the legislative history indicates that Congress disagreed with the Commissioner's determination that the penalty and the interest are two separate transactions.[32] Indeed, as the Seventh Circuit noted, the 1974 amendment did not disturb the requirement that the depositor report *all* interest as

[32]The brief legislative history of this provision contains two references to the Revenue Ruling, but no expression of disapproval of the conclusion that the penalty and the interest represent two separate transactions. See H. R. Conf. Rep. No. 1405, 93d Cong., 2d Sess. 5 (1974); 120 Cong. Rec. 28,117 (1974) (Sen. Church).

income (including interest forfeited as a penalty) and then address the penalty separately as a loss—a requirement explicitly grounded in the Commissioner's determination that the interest and the penalty represent separate transactions. See *Colonial*, 854 F. 2d at 1007.[33]

The court of appeals below erroneously deemed Rev. Rul. 73-511 and Congress's response to the ruling irrelevant. Pet. App. 24a-28a. The court viewed the ruling as "ambiguous" with respect to whether the payment of interest by the financial institution to the depositor and the payment of the penalty by the depositor to the financial institution constitute two separate transactions. Pet. App. 25a. The court found ambiguity where none exists. The ruling states that "the interest paid or credited [*i.e.*, the payment of interest] and the forfeiture incurred [*i.e.*, the payment of the penalty] represent two separate transactions." 1973-2 C. B. at 403.[34] The court also stated that, in its view, even if the ruling did say that payment of interest and the payment of principal are two separate transactions, the ruling "never says that two separate *obligations* are involved." Pet. App. 26a. If payment of interest and payment of the penalty are required to be treated as separate transactions, however, it is because they are regarded by the ruling as fulfilling separate obligations.[35]

[33]Relying in part on the rationale of Rev. Rul. 73-511, the Commissioner ruled in Rev. Rul. 83-60, 1983-2 C.B. 39, that early withdrawal penalties do not result in income from discharge of indebtedness excludable from income under Section 108.

[34]The court of appeals also seemed to ascribe significance to the fact that Rev. Rul. 73-511 did not discuss the payment of principal. Pet. App. 25a. The ruling did not discuss the payment of principal because, in the situation presented in the ruling, the depositor paid the penalty out of interest. See 1973-2 C.B. at 403 (the penalty was paid by "the forfeiture of a portion of the interest previously paid"). Nothing in the ruling, or in the nature of the penalty, suggests that the result would be different where the penalty is paid in part out of principal.

[35]The court of appeals also rejected the significance of the congressional response to the Revenue Ruling, but explicitly based that conclusion on the court's reading of the Revenue Ruling itself. Pet. App. 28a.

4. The conclusion that respondent's receipt of early withdrawal penalties does not result in income from discharge of indebtedness also reflects the purpose of Section 108. That purpose was to grant relief to taxpayers to strengthen their financial position through debt reduction. See note 25, *supra*.[36] The relief comes in the form of deferral of taxation of the resulting debt discharge income. Current taxation of that income might discourage debtors from reducing their debt, because the debt discharge transaction would not generate any cash with which to pay the tax. In the typical instance of discharge of indebtedness income, the debtor has income from the discharge, but has received no cash or property. See *Colonial*, 854 F. 2d at 1007 (the usual Section 108 transaction "does not add cash" to the debtor's business). Indeed, the debtor has usually expended cash to discharge the debt.

Section 108 was intended to give debtors "an incentive to liquidate their indebtedness." H.R. Rep. No. 855, *supra*, at 5. See also S. Rep. No. 1631, *supra*, at 78. Yet here the debtor, respondent, had no control over the liquidation of its indebtedness; early withdrawal is a unilateral choice of the depositor-creditor. We do not suggest that Section 108 can never apply to creditor-initiated transactions. But where the debtor has *no* control over the transaction, the purpose of Section 108—to give debtors an incentive to reduce their debt by removing an impediment to debt reduction—simply does not

[36]In reviewing the purpose of Section 108, we do not contend, contrary to the suggestion of the court of appeals (Pet. App. 14a-15a), that Section 108 was limited to insolvent companies; clearly, it was not. But particularly in view of the fact that, in the court of appeals' own assessment, the applicability of Section 108 to respondent's penalties is "admittedly difficult" and "many of the questions raise evenly balance[d] considerations" (Pet. App. 28a), it is appropriate to consider the purpose of the provision in determining whether the early withdrawal penalties are within it. In light of the court's observation that many of the questions are "evenly balance[d]" it is also noteworthy that, as the Seventh Circuit correctly pointed out (854 F. 2d at 1006), it is the taxpayer who bears the burden of establishing that particular income is entitled to the special benefit of an exclusion provision.

apply. The depositor's decision to make an early withdrawal will not be affected by the tax treatment of the savings institution.[37]

In sum, respondent's offset of penalties for early withdrawals represents a method of payment for a separate obligation and thus is not "income by reason of the discharge * * * of indebtedness" within the meaning of Section 108 and its special tax benefit; consideration of the purpose of Section 108 highlights the incongruity of a contrary conclusion.

[37]The court of appeals cited (Pet. App. 23a) several cases in which the creditor, rather than the debtor, initiated a transaction that resulted in income from discharge of indebtedness. *Sutphin* v. *United States*, 14 Cl. Ct. 545 (1988); *Michaels* v. *Commissioner*, 87 T.C. 1412 (1986); *Reliable Incubator & Brooder Co.* v. *Commissioner*, 6 T.C. 919 (1946); see Rev. Rul. 82-202, 1982-2 C.B. 36. In those cases, however, the creditor-initiated transaction took place only because the debtor agreed to the transaction. Here, by contrast, respondent had no control over the transaction. Moreover, in those cases the forgiven debt was the result of bargaining between debtor and creditor, whereas here the penalty was imposed from outside the parties' debtor/creditor relationship.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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* The Solicitor General is disqualified in this case.

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RESPONDENT'S

BRIEF

QUESTIONS PRESENTED

1. Whether respondent realized a loss upon the exchange of interests in 420 mortgage loans for interests in 377 different mortgage loans?

2. Whether amounts forfeited by depositors upon early withdrawal of their certificates of deposit were income to respondent by reason of the discharge of indebtedness?

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

No. 89-1926

UNITED STATES OF AMERICA,
Petitioner

v.

CENTENNIAL SAVINGS BANK FSB
(RESOLUTION TRUST CORPORATION, RECEIVER),
Respondent

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT

STATEMENT

1. **Loss on Exchange of Mortgage Loans.** This issue arises from respondent's[1] decision to dispose of a 90% interest in 420 separate mortgage loans in exchange for a 90% interest in 377 different mortgage loans owned by the Federal National Mortgage Association ("FNMA"). The 90% interest disposed of by respondent had a face value and tax basis of $8.4 million but a fair market value of only $5.6 million. Pet. App. 2a. Respondent

[1] While this case was pending on appeal in the circuit court below, Centennial was found insolvent by the Federal Home Loan Bank Board ("Bank Board") and the Federal Savings and Loan Insurance Corporation ("FSLIC") was appointed as receiver. Subsequently, pursuant to the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), the Resolution Trust Corporation took over as receiver. FIRREA, § 501, 12 U.S.C. § 1441a (Supp. 1990). Accordingly, the Resolution Trust Corporation as receiver for Centennial is the respondent in this action. However, for ease of reference Centennial is referred to as the respondent throughout this brief. Centennial has no parent companies or non-wholly owned subsidiaries.

deducted the $2.8 million difference as a loss on its 1981 tax return. The loss contributed to a net operating loss for 1981 that was carried back to offset income previously reported in the years 1969 through 1980, producing a refund of taxes. Pet. App. 3a.

The critical fact—antecedent to any legal analysis—is that respondent had experienced a very real, very large loss on loans which it had made in the expectation of profit and on which it had previously reported profits in its tax returns.

The historical core business of the savings and loan ("S&L") industry is to accept interest-bearing deposits and use the funds deposited to make home mortgage loans. In economic terms, the industry borrows "short" (*i.e.*, from depositors, who can withdraw on demand or on short maturities) in order to re-lend "long" (*i.e.*, under mortgage loans binding the S&L to interest expense at fixed rates over long terms). During periods of stable interest rates, loans that do not default are normally profitable loans for an S&L because the long-term rates paid by its borrowers generally exceed the short-term rates that it must pay to its lenders (depositors). But if short-term rates climb in the marketplace above the long-term rates fixed in the S&L's outstanding loans, the loans quickly lose profitability and, accordingly, value.[2]

For much of the industry's history, stable interest rates existed, at least partly because Congress fixed the maximum rate at which financial institutions could borrow from depositors and money-market mutual funds did not exist to draw funds away. But, in the late 1970's, inflation running at an unprecedented rate was accompanied by radical increases in both short- and long-term interest rates, an inversion of the yield curve and the emergence of money market mutual funds. The effect on the industry was disastrous. See White, *The S&L Debacle: How It Happened and Why Further Reforms Are Needed*, CATO Review of Business & Government 11 (Winter 1990).

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[2] This circumstance can occur either in abnormal periods when short-term rates exceed long-term rates (generally referred to as an "inversion of the yield curve") or when interest rates increase across the board to a level at which new short term rates exceed prior long-term rates.

For example, in 1981 and 1982 account withdrawals at S&Ls exceeded new deposits by $32 billion. Most of the withdrawn funds moved to money market mutual fund accounts that were paying significantly higher rates. R. Dan Brumbaugh, Jr., Thrifts Under Seige 39-40 (1988). To stem this flood of withdrawals, the federal regulators relaxed interest rate restrictions by allowing S&Ls to offer accounts at market-related interest rates. *Id.* 40-43. However, that caused S&Ls to incur significant operating losses that threatened their net worth because the income on their old, pre-existing mortgage loan portfolios was not sufficient to offset their higher costs of funding those loans by borrowing from depositors at the new market rates. *Id.*

The radically changed economic environment caused pre-existing loan portfolios of S&Ls, including respondent's, to suffer substantial losses in profitability and value, sufficient in many cases to threaten the S&L's solvency. In 1981, respondent's mortgage loan portfolio was composed primarily of fixed-rate, long-term mortgage loans that had been issued in the late 1960's at interest rates significantly lower than the rates it was currently forced to pay depositors in order to retain their accounts. Respondent disposed of interests in 420 of its older mortgage loans in order to "realize" for tax purposes the real $2.8 million "loss" in value that had occurred and to offset that loss against income previously reported as taxable income. There is no question about either the reality or the magnitude of the loss. Both were validated in the marketplace and emphatically reconfirmed by respondent's subsequent insolvency.

There is also no question about the bona fides of the disposition transactions. They effected a complete disposition of 90% of respondent's interest in 420 separate, identifiable mortgage loans in exchange for participation interests in 377 other, different mortgage loans owned by FNMA. Perhaps the single most common, garden-variety tax planning transaction engaged in by investors in stocks and securities is to dispose of devalued stocks and securities at year-end in order to realize a tax loss, and then to reinvest the proceeds in similar stocks and securities of different issuers. Respondent did no more. Respondent was not avoiding

tax or obtaining any special tax treatment that was unavailable to all taxpayers generally.[3]

The genuineness of respondent's loss, the bona fides of the exchange transaction and the propriety of realizing losses by disposition in order to carry such losses back to offset prior income are not challenged by petitioner.

In essence, petitioner is arguing that respondent did not "realize" the loss because it disposed of the loan interests in a transaction that was encouraged by the Bank Board's adoption of a regulatory accounting rule.

For a brief period beginning in 1980, the Bank Board promulgated a special regulatory accounting rule, Memorandum R-49, that, in the case of mortgage exchanges of the kind here in issue, gave S&Ls the option of not recording a "loss" for regulatory accounting purposes, and thereby avoiding reduction in regulatory capital.[4]

The Bank Board as both the regulator of the S&L industry and the head of the FSLIC—the fund that covered losses in insolvent S&Ls—was fundamentally concerned with the solvency of the

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[3] The Internal Revenue Code permits all taxpayers to dispose of devalued assets in order to realize an accrued loss, reduce current taxable income and carry any excess loss back to prior years to offset income reported in those years so as to obtain a tax refund. The loss carryover/carryback rules in Section 172 of the Code mitigate the arbitrariness of the requirements that taxable income be calculated and reported on an annual basis, with no allowance for accrued but unrealized losses. To ensure that S&Ls not pay tax where no income exists, thus protecting deposits and depositors, section 172 provided, in the year in issue, a special 10-year carryback for S&Ls, in contrast to the 3-year carryback applicable to other corporations.

[4] Regulatory capital was based upon regulatory accounting principles that were determined by the Bank Board and differed in many significant respects from generally accepted accounting principles (GAAP). For example, qualifying subordinated debentures, although promissory notes, were treated as capital under regulatory accounting but not GAAP. As noted in Respondent's Brief in Opposition to the Petition for Certiorari, 18-19 and n.14, in 1989, Congress both abolished the Bank Board and required regulatory accounting principles to follow GAAP. GAAP now provides for recordation of gain or loss on most reciprocal mortgage exchanges. *Id.*

S&Ls it regulated. From the regulatory point of view of policing solvency, it was obviously desirable that S&Ls be able to "realize" for tax purposes the losses that had in reality been sustained in the marketplace and, thus, to recover tax paid on profits reported earlier that, in retrospect, had been overstated. The tax refunds would enhance solvency, as well as reflect reality. Yet the concurrent recording of such losses in the regulatory accounts would in many cases have caused an S&L to fall below the Bank Board's minimum regulatory capital and liquidity requirements, and automatically trigger adverse regulatory consequences that were worse than any benefit the S&L might derive from the tax refunds.

Since solvency really turned on underlying current value, and not on what was recorded in historical cost accounts, the Bank Board not unnaturally sought to eliminate formal regulatory accounting loss recognition rules that would discourage an S&L from taking the self-help steps to improve its cash position. Any income tax reduction or refund would provide additional operating income to help alleviate operating losses attributable to the high cost of borrowing. Because the mortgage loan exchanges permitted under Memorandum R-49 would produce cash, without any offsetting adverse effect (as the qualifying conditions prevented any effect on the S&L's underlying current value at the time of the exchange and minimized the risk that there would be significant effects later on), the Bank Board believed that Memorandum R-49 enhanced solvency.

In characterizing the exchanges that qualified under Memorandum R-49, the Memorandum used the phrase "substantially identical." Petitioner contends that because of this characterization, the exchanges cannot result in "realization" of a loss for federal income tax purposes. Pet. Br. 25. Were it not for the existence of that short-lived regulatory characterization, respondent believes that the Internal Revenue Service ("IRS") would never have challenged the deductibility of the loss in this case, because the argument petitioner now makes is inconsistent not only with all precedent, but with the position the IRS has long, adamantly and successfully taken with respect to the "realization" of gains and losses.

Under Section 1001 of the Internal Revenue Code of 1954 ("Code"),[5] which petitioner relies on here, gains and losses are treated alike. The IRS—with its eye on maximizing the taxation of gain—has always contended that even the most formal and insubstantial change in the ownership of assets results in a disposition and in "realization" of gain or loss. The courts have endorsed that view except in those cases that can be made to fit within the narrow parameters of *Eisner* v. *Macomber*, 252 U.S. 189 (1920), where the taxpayer had in reality the same interest in the same thing both before and after the "disposition."

There is no question that, after the exchange, respondent did not have the same interest in the same thing that it had before. The participation interests transferred by respondent represented 420 individual mortgage loans that differed substantially from the 377 loans represented by the participation interests received from FNMA. The most basic difference was that each of the 797 loans had a different obligor and was secured by different property. The geographic and demographic characteristics of the loans were also different. J.A. 30-42, 51-54. FNMA sought to increase its holdings of mortgage loans secured by urban properties, and the interests transferred by respondent to FNMA represented loans that were heavily concentrated in urban areas in North Texas, while the interests that FNMA transferred to respondent represented loans that were dispersed throughout the state, primarily in non-urban areas. Pet. App. 8a. Further differences were that, compared to the loans disposed of, respondent received interests in loans that were to borrowers having 40% higher average net worths and less tendency to move, and had lower loan-to-value ratios, lower delinquency rates, and a lower tendency to prepayment. *Id.;* Pet. App. 39a, J.A. 41 All of these differences resulted in significantly different payment experiences. Pet. App. 8a. Over five years, the loans represented by the interests respondent transferred to FNMA experienced $712,000 more in prepayments, J.A. 41, and had a higher rate of delinquency than the loans in which respondent acquired an interest from FNMA, J.A. 30, Pet. App. 39a.

[5] Unless otherwise indicated, statutory references are to the Internal Revenue Code of 1954, as in effect for the year in issue.

It is astonishing that the IRS is ignoring the many real, substantial differences between the exchanged interests in mortgage loans because a decision on the ground it urges would be contrary to principles it aggressively sought over 70 years of history and would open new horizons for taxpayers planning the avoidance of taxable gain. If petitioner's position were upheld in this case, a new, highly subjective standard for the realization of gain or loss would be substituted for settled law. There would be endless litigation of an intensely factual nature. The courts would be faced with an interminable struggle to give shape and content, bit-by-bit, to a new standard which, by its nature, could never be objective or precise. That kind of standard would be a burden on both tax administration and the courts.

2. **Income by Reason of Discharge of Indebtedness.** This issue arises as a result of the decision of depositors to withdraw prematurely principal amounts that had been deposited with respondent pursuant to certificates of deposit ("CDs"). CDs, unlike regular demand and savings accounts, have a fixed term. Each CD fixed the term of deposit and provided that if the CD holder wished to withdraw the deposit before maturity, the depositor would forfeit a portion of its principal.[6] In 1981, as a result of premature withdrawals, holders of CDs forfeited $258,019 of deposits. Pet. App. 4a. Pursuant to Code Section 108, respondent treated this $258,019 as income realized "by reason of the discharge of indebtedness." Application of Section 108 had the effect of deferring and collecting the tax on the discharge of indebtedness income through lower depreciation deductions for the reduced-basis property, or through greater taxable gains on the sale of the reduced-basis property.

Forfeitures of principal upon early withdrawals of CDs are integrally related to an S&L's business of borrowing "short-term" from depositors at prescribed interest rates and relending "long-term" at higher interest rates. In a rising interest rate environ-

[6] The CDs prescribed interest at a specified rate. With some exceptions not relevant here, earned interest was credited to a depositor's account on specified earnings distribution dates. Interest credited could be withdrawn without forfeiture at any time. J.A. 27-29.

ment, the CD depositor wants his funds back so he can reinvest them at higher interest rates, but the financial institution does not want to part with its CD deposits because it has invested the funds in assets with fixed maturities and cannot replace the deposits at the same cost. This inherent tension between a CD holder's desire for premature withdrawal at will and the institution's desire to forestall premature withdrawal, even if left unregulated, would cause the debtor and creditor to negotiate, in advance or at the time of withdrawal, a forfeiture of principal upon premature withdrawal of CD funds. The importance of premature withdrawals has led to the promulgation of a federal regulation prescribing minimum forfeitures for CDs in order to attempt to influence the volume of premature withdrawals. See Federal Depository Institutions Deregulation Committee Regulation, 12 CFR 1204.103, (1981). Resp. Br. in Opp 2-3.

The court of appeals below recognized that the reduction of principal indebtedness on a premature withdrawal of a CD exemplifies the "classic case" in which income arises by reason of the discharge of indebtedness. The court quoted a noted tax commentator, who described the classic case as a "financial adjustment in which a creditor accepts less than the face amount of a debt in full payment, . . . because a rise in the interest rate for comparable loans has made the old debt worth less than its face amount." Pet. App. 13a, quoting Bittker and Thompsen, *Income from the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber Co.*, 66 Calif. L. Rev. 1159, 1174 (1978).

SUMMARY OF ARGUMENT

1. **Loss on Exchange of Mortgage Loans.** Respondent disposed of participation interests in 420 mortgage loans in exchange for participation interests in 377 different mortgage loans. Because the interests disposed of had an aggregate tax basis which exceeded the fair market value of the interests received, respondent determined that it had "realized" a loss on the exchange in the amount of the difference, pursuant to Code Section 1001(a) and (b). Respondent also determined that the loss was "recognized" pursuant to Code Section 1001(c) because no other Code provision applied to deny such recognition.

While a taxpayer holds property, mere increases or decreases in the property's value are not considered income or loss subject to taxation under the Code. Income or loss is "realized" only upon the occurrence of an objective event, such as a disposition of the property. In a line of cases beginning with *Eisner* v. *Macomber*, 252 U.S. 189 (1920), that has stood for 70 years, this Court established a very low threshold for determining what constitutes a disposition of property that causes appreciation or depreciation in the property's value to be "realized" as income or loss for taxation purposes. Under the Court's test, every exchange is a "disposition" and therefore an event sufficient to cause "realization" of income or loss, unless the taxpayer received in exchange the same interest in the same property that he had before, in which case there is, in reality, no "disposition". Petitioner's brief admits that the "materially different" phrase in Treas. Reg. § 1.1001-1(a), upon which its entire argument is based, is simply reflective of the "realization" standard delineated by this Court in the *Eisner* line of cases.

As respondent disposed of an interest in 420 loans in exchange for an interest in 377 different loans, and changed its economic position as a result, it realized a loss under this Court's test.

By setting a minimal threshold that causes virtually every exchange to produce "realization" of income or loss, it was left to Congress to determine those instances in which income or loss, although "realized", should not be "recognized" *i.e.* taken into account for computing tax. Congress, with its eye on revenue from gains, has constructed the present day Code, bit-by-bit over the years, on the foundation of this Court's minimal realization principle. Since 1924 the Code has been premised on the general rule that all "realized" gain or loss is to be taken into account, *i.e.* "recognized," unless Congress has prescribed an explicit statutory exception.

The twin concepts of "realization" and "recognition" are fundamental in the Code. The words are used as terms of art and the concepts are implicit in a myriad of Code provisions. The resulting statutory framework, which includes specific "nonrecognition" rules for exchanges of "like-kind" properties and "wash sales" of certain "substantially identical" properties, demonstrates unmis-

takably that Congress could not possibly have intended petitioner's interpretation of Code Section 1001. It is clear from both the Code's language and its structure that loss is to be recognized upon the exchange of mortgage loans, *even if* they are of "like-kind," and *even if* they are "substantially identical", as those terms are defined in the Code and Treasury Regulations. Against that background, it is inconceivable that either Congress or the IRS would have intended eight words in an administrative regulation adopted in 1934 to reverse that result.

Petitioner's argument is an attempt to create a new nonstatutory, nonrecognition rule that is incompatible with other express nonrecognition rules, in the guise of a realization standard that has never existed. The "material difference" phrase is not a separate rule overlaid on, and vitiating, large segments of the statutory nonrecognition rules. Rather, it simply reflects the minimal threshold for realization established in the Court's *Eisner* line of cases. Petitioner's rule is incapable of precise articulation and application, has no support in the case law and, as the court of appeals noted, would greatly complicate tax administration by requiring inquiry into a host of factual issues that would preclude objective and neutral application of the bedrock principle of realization.

2. **Income by Reason of Discharge of Indebtedness.** Respondent realized income as a result of a recurring event, the discharge of a portion of respondent's indebtedness to CD holders upon an early withdrawal of principal by those depositors. But for the depositors' decisions to withdraw funds before maturity and accept the forfeiture of a portion of their deposits, the income at issue would never have come into existence. Under this Court's decision in *United States v. Kirby Lumber*, 284 U.S. 1 (1931), a debtor realizes "discharge of indebtedness income" as a result of satisfying indebtedness for an amount less than that which is owed. In this case, respondent satisfied debts to depositors by returning principal amounts less than had been borrowed.

Code Section 108 as then in force permitted respondent to elect to include income arising "by reason of the discharge of indebtedness" gradually, rather than all at once *i.e.*, to exclude it initially and then restore it over time by reducing the basis of depreciable

property in like amount. The income at issue qualified for the Section 108 election because it arose only "by reason of," and would not have arisen "but for," the discharge of debt upon the termination of the debtor-creditor relationship.

Petitioner seeks to characterize respondent's income as the receipt of a penalty obligation so as to argue that the discharge of its indebtedness to depositors did not itself create income, but was only a medium of payment for other income. However, petitioner fails to identify how respondent would have realized any "other" income if the CD had not been withdrawn prematurely. The forfeitures received by respondent upon early withdrawals of CDs clearly gave rise to income "by reason of the discharge of indebtedness" and not by reason of any independent obligation owed by the depositors.

ARGUMENT

I. RESPONDENT REALIZED A LOSS UPON THE EXCHANGE OF INTERESTS IN 420 MORTGAGE LOANS FOR INTERESTS IN 377 DIFFERENT MORTGAGE LOANS

A. The Threshold for Realization of Gain or Loss on the Disposition of Property in an Exchange Is that an Interest in Different Property Be Received

Petitioner has correctly characterized the issue here as whether there has been a "realization" of loss under Code Section 1001. Pet. Br. 13-14. Code Section 1001 provides:

> (a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
>
> (b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the full market value of the property (other than money) received.

That language signifies that gain or loss is "realized" upon any disposition of property, whenever the adjusted basis of the property differs from the value received in exchange.

Section 1001(c) then provides that all gain or loss "realized" will be taken into account in computing taxable income, unless Congress has provided that it shall not be "recognized."[7] Section 1001(c) reads:

> (c) *Recognition of Gain or Loss.*—Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

Both parties and every court that has considered the issue agree that no statutory "nonrecognition" provision applies to dispositions of mortgage loans through reciprocal sale transactions. Thus, if gain or loss is "realized" upon such a disposition, it is to be "recognized."

The standard for when income is "realized" is founded in this Court's decision in *Eisner* v. *Macomber*, 252 U.S. 189 (1920). Petitioner concedes this, and that neither Section 1001 nor its predecessors were intended to change the law that was developed by this Court in *Eisner* and decisions that followed. Pet. Br. 13 n.9.

The question in *Eisner* was whether a taxpayer "realized" income upon the receipt of a pro rata stock dividend. The 1916 Revenue Act expressly included stock dividends, to the extent of their cash value, in its definition of income. Revenue Act of 1916, ch. 463, § 2(a), 39 Stat. 757. The taxpayer challenged the government's assertion that tax was payable on the receipt of the stock dividend, claiming it was not income within the meaning of the recently passed 16th Amendment to the Constitution, but a

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[7] The Code contains numerous sections providing that gains and losses realized through the disposition of property should nevertheless not be taken into account in determining the taxpayer's tax liability in the year of disposition. The Code uses the term "recognition" to denote the fact that any particular item of income, gain, expense, or loss is to be included in the calculation of tax liability for the year. An item which is to be so included is said to be "recognized," and an item not to be included is said to be not "recognized."

direct tax on property in violation of the Constitutional requirement that direct taxes be apportioned according to population.

The Court first distinguished income from mere growth in the value of capital, stating that income is

> *not* a gain *accruing to* capital, not a *growth* or *increment* of value in the investment, but a gain . . . *proceeding from* the property, *severed from* the capital . . . . 252 U.S. at 207 (emphasis original).

Viewed this way, a stock dividend represents only growth in the value of property and, therefore, no income is "realized" from it:

> We are clear that not only does a stock dividend really take nothing from the corporation and add nothing to that of the shareholder, but that the antecedent accumulation of profits evidenced thereby, while indicating that the shareholder is the richer because of an increase of his capital, at the same time shows he has not *realized* or received any income in the transaction. 252 U.S. at 212 (emphasis supplied)

The realization principle was further developed by this Court in five subsequent cases, decided in the ensuing five years. *United States* v. *Phellis*, 257 U.S. 156 (1921); *Rockefeller* v. *United States*, 257 U.S. 176 (1921); *Cullinan* v. *Walker*, 262 U.S. 134 (1923); *Weiss* v. *Stearn*, 265 U.S. 242 (1924) and *Marr* v. *United States* 268 U.S. 536 (1925). All of those cases involved distributions and exchanges of stock and securities in the context of corporate reorganizations. In each case, the corporate structure was changed and the taxpayer, as shareholder, received shares in new corporations either in addition to, or in exchange for, the shares held in the original company. In each case the question was whether the shareholder "realized" income upon the receipt of the new shares. In four of the cases, this Court held that the additional value in the new shares was "realized" and taxable because receipt of the shares gave the shareholders a different interest in a different corporation. In the other case, income was not "realized" because the identity of the shareholder's interest was preserved.

In the first case, *United States* v. *Phellis*, the DuPont Company of New Jersey transferred its assets to a newly formed corpora-

tion, DuPont of Delaware, in exchange for debentures and common stock. DuPont New Jersey distributed the new DuPont Delaware stock to its shareholders as a dividend. The shareholders and officers of the two corporations were the same and the aggregate market value of the DuPont Delaware and DuPont New Jersey stock held by any shareholder after the reorganization exactly equalled that of the DuPont New Jersey stock held before the reorganization. This Court upheld the government's assertion that a shareholder in DuPont New Jersey prior to the reorganization was required to include in income the full value of the shares of DuPont Delaware stock that he had received, because the two corporations were incorporated in different states, had different capitalizations, and different amounts of authorized stock:

> In the light of all this we cannot regard the new company as virtually identical with the old, but must treat it as a substantial corporate body with its own separate identity, and its stockholders as having property rights and interests *materially different* from those incident to ownership of stock in the old company. 173 U.S. at 156 (emphasis supplied).

Phellis introduced the "materially different" phraseology, and in applying it focused on the formal legal distinctiveness of the two corporations. Implicit in this legal distinctiveness was that different consequences, economic as well as non-economic, could result to the shareholders as a result of their property being subject to different legal rules and jurisdictions.[8] Although the potential for different consequences in the future had not caused an immediate change in the market price of the stock, a fact the lower court relied on to determine that the shareholder had not realized income, this Court reversed, holding that a comparison of pre-distribution and post-distribution stock values was "a circumstance of no particular importance" in determining whether the shareholder had realized income. 257 U.S. at 170.

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[8] If there were no potential, practical differences, the change in incorporation from New Jersey to Delaware would presumably not have been made. Recent takeover litigation illustrates that different legal rules in different states can produce vastly different economic effects.

The next two cases, *Rockefeller* v. *United States*, and *Cullinan* v. *Walker*, involved the split-up of a vertically integrated oil company into separate production and distribution companies, and the distribution of stock in a new company to the shareholder either in addition to, or in exchange for, the stock of the old company. In each case, the Court followed *Phellis* and held that the stock of the new company was materially different from the stock of the old company so that income was realized upon the receipt of the stock of the new company.

In *Weiss* v. *Stearn*, the Court rejected the attempt to tax a sole stockholder in full on the exchange of stock in his corporation for cash and one half of the stock of a new corporation, incorporated in the same state and to which all of the assets of the original corporation had been transferred. The Court held that the transaction should be treated as if the old stockholder disposed of only one-half of his stock for cash.

The holdings of realization in *Phellis*, *Rockefeller* and *Walker* and nonrealization in *Eisner* and *Weiss* were explained and reconciled by the Court the next year in *Marr* v. *United States*. *Marr* involved the shift of the state of incorporation of General Motors from New Jersey to Delaware. The government asserted that the exchange of stock in General Motors, New Jersey for stock in General Motors, Delaware caused gain or loss to be "realized" by the shareholders, because "the gain actually made is represented by securities with essentially different characteristics in an essentially different corporation." 268 U.S. at 540.

The Court upheld the government, and reconciled the earlier cases as follows:

> In each of the five cases named, as in the case at bar, the business enterprise actually conducted remained exactly the same. In *United States* v. *Phellis*, in *Rockefeller* v. *United States* and in *Cullinan* v. *Walker*, where the additional value in new securities distributed was held to be taxable as income, there had been changes of corporate identity. That is, the corporate property, or a part thereof, was no longer held and operated by the same corporation; and, after the distribution, *the stockholders no longer owned merely the same proportional interest of the same character in the same*

corporation. In *Eisner* v. *Macomber* and in *Weiss* v. *Stearn*, where the additional value in new securities was held not to be taxable, *the identity was deemed to have been preserved*. In *Eisner v. Macomber* the identity was literally maintained. There was no new corporate entity. The same interest in the same corporation was represented after the distribution by more shares of precisely the same character. * * * That is, *there was an exchange of certificates but not of interests*. In *Weiss* v. *Stearn* a new corporation had, in fact, been organized to take over the assets and business of the old. *Technically there was a new entity; but the corporate identity was deemed to have been substantially maintained because the new corporation was organized under the laws of the same state, with presumably the same powers as the old*. There was also no change in the character of securities issued. * * * Thus, in *Weiss* v. *Stearn*, as in *Eisner* v. *Macomber*, the transaction was considered, in essence, an exchange of certificates *representing the same interest, not an exchange of interests*.

> In the case at bar, *the new corporation is essentially different from the old*. A corporation organized under the laws of Delaware does not have the same rights and powers as one organized under the laws of New Jersey. *Because of these inherent differences in rights and powers, both the preferred and the common stock of the old corporation is an essentially different thing from stock of the same general kind in the new*. 268 U.S. at 540-42 (emphasis supplied).

The Court's decision in *Marr* firmly established the principle that every exchange of interests in different properties necessarily can produce different consequences and that gain or loss on such an exchange is "realized." There is non-realization only if, in the language of *Marr*, the exchange involves an "exchange of certificates, representing the same interest, not an exchange of interests."

From a revenue point of view, the desirability of this minimal, bright-line threshold for realization is apparent when one considers that it applies to gain as well as loss, and obviously works to maximize the realization of gain. From a tax administration point of view, the desirability of a bright line test that avoids subjective factual disputes is equally apparent.

B. The Participation Interests in 377 Individual Loans Received by Respondent Were Different from the Interest in the 420 Loans That Respondent Disposed of and Caused Loss to Be Realized on the Disposition

Unquestionably, the mortgage loan interests represented by the participation certificates received by respondent were sufficiently different from the interests represented by the participation certificates exchanged to cause gain or loss to be realized under the *Eisner* line of cases.

Most significantly, the participation certificates received represented obligations of obligors different from the obligors under the participation certificates exchanged. Moreover, the notes and mortgages differed because the mortgages represented security interests in different properties. Finally, the geographic distribution of the mortgaged properties varied. As noted by the court of appeals below, the uniqueness of every individual obligor and parcel of real estate is fundamental:

> It is elementary in the law that real property, even residential property of the same general value, is unique. So is each person. Because the value of the mortgages depends on the performance of these unique entities (people in paying their obligations and real estate in retaining its value in the market) an exchange of residential mortgages is not like swapping identical fungible commodities. *San Antonio Savings Association* v. *Commissioner*, 887 F.2d 577, 591 (5th Cir. 1989), petition for cert. pending No. 89-1928.

This is exactly the rationale of the *Eisner* line of decisions. Legally distinct properties can perform differently. Evidence was presented at trial to demonstrate that different obligors and different collateral would necessarily be expected to generate different payment and delinquency consequences and that such differences occurred in fact in this case.[9]

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[9] Different obligors and collateral mean *inter alia*, differences in age, marital and family status, income and wealth of the obligors and in location, construction, size, style and age of the collateral. See J.A. 30-42, 51-54. The Tax Court in *FNMA* v *Commissioner*, 90 T.C. 405, 423 (1988), *aff'd* 896 F.2d 580 (D.C. Cir. 1990), petition for cert. pending No. 89-1987, commenting on the testimony of the taxpayer's expert John P. Danforth that, given different obligors and

Not only were the obligors and collateral underlying the interests exchanged materially different, but like the certificates received in each of the *Eisner* line of cases where income was realized, the exchange left respondent with participation certificates representing a type of property interest different from the type of property interest it had prior to the exchange. Prior to the exchange, respondent owned whole loans and mortgages. As a result of the exchange, respondent owned 10% participation interests in the whole loans and mortgages it previously owned and 90% participation interests in different loans and mortgages. This difference is significant because, as found by the Tax Court in *Cottage Savings Association* v. *Commissioner*, 90 T.C. 372, 383, 390 (1988), rev'd, 890 F.2d 848 (6th Cir. 1989), cert. granted No. 89-1965 (Oct. 1, 1990), participations are less marketable than whole loans.

In brief, the threshold for realization developed by this Court in the *Eisner* line of cases was fashioned to determine when appreciation in the value of property became "income" subject to tax. That threshold is very low; it is crossed whenever an interest in property is exchanged for an interest in other legally distinct property. Without question, under this test, the interests in the 420 loans disposed of were different property from the interests in the 377 loans received.

The inquiry should end here in respondent's favor since it "realized" a loss and no nonrecognition provision applied.[10]

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collateral, it would be an "incredible coincidence" for exchanged mortgaged interests to perform in an identical fashion, stated: "We think that this reflects reality and common sense."

[10] Since Code § 1001 establishes the same test for realizing gain or loss, if petitioner prevails it will create a rule that would avoid realization of gain on exchanges such as these. This would have very real consequences. The major concern of every member of the S&L industry today is to increase capital. Today, regulatory accounting is required to follow GAAP, see n. 4, *supra*, p. 4, and GAAP requires that gain or loss be recorded upon an exchange of loans having different obligors. If this Court holds that different obligors and collateral are immaterial to realization, S&Ls can be expected to enter into exchanges of appreciated mortgage loans on a widespread basis in order to record gains for book purposes since that will build capital for regulatory purposes with no tax cost. The effect of adopting petitioner's argument would be to permit S&Ls to record accrued appreciation but not accrued depreciation, a selective mark-to-market which can only serve to distort the true capital position of the S&L.

C. Both the Statutory Scheme and Longstanding Treasury Regulations Reflect that the Threshold for Realization Upon a Disposition of Property in an Exchange Is that an Interest in Different Property Be Received

Petitioner's entire argument against realization rests upon a phrase, "differing materially either in kind or in extent," which appears in Treas. Reg. § 1.1001-1(a), but not in the statute:

> Reg. § 1.1001-1 *Computation of gain or loss.*
>
> (a) *General rule.* Except as otherwise provided in Subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

The phrase, "differing materially either in kind or in extent," was added to the Treasury regulations in 1934—56 years ago—without explanation and without any statutory change or other known event to explain the reason for adding it.[11] That phrase, and similar phrases, were used by this Court in the *Eisner* line of cases to establish the realization threshold. Accordingly, the only sensible construction of the phrase is that it was intended to reflect the, by then well-established, realization principle set forth in those cases.

Petitioner concedes that any requirement that exchanged properties must be "materially different" in order to cause the realization of income derives from the *Eisner* line of cases. Pet. Br. 15 n.10. Because, the exchange here so clearly crosses the realization threshold established in those cases, it is mystifying why this case has arisen.

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[11] The CCH tax service for 1935 notes only that this article of the regulations was entirely rewritten (considerable language dealing with other aspects of the statute not relevant having been added), but that "no change in principle" was intended except with respect to a point not relevant here. CCH 1935 Federal Income Tax Service, Vol. I, ¶ 697.01.

Yet notwithstanding that concession, petitioner essentially ignores the *Eisner* line of cases and argues that the regulatory phrase has an expansive new meaning—requiring an ill-defined economic analysis. Petitioner points to no provision in the statute, the legislative history or the *Eisner* line of cases that supports its expansive new interpretation. Further, its interpretation is fundamentally at odds with the overall statutory framework and incapable of effective administration.

The basic structure of the Code is that gain or loss is realized upon every disposition of property for consideration, and that realized gain or loss is taken into account unless an express statutory nonrecognition provision applies. The "differing materially either in kind or in extent" phrase in the Treasury Regulations fits with this structure insofar as—and only insofar as—it is read as incorporating the threshold for realization prescribed in the *Eisner* line of cases. Under those cases, realization is tested under an objective standard that requires only that an interest in property be exchanged for a different interest in property. Realization is not attained only if there is an exchange of certificates but no change in property rights, *i.e.*, an "exchange" in which the interest originally held was never really disposed of.[12]

The minimal realization principle is codified in Code Section 61's all-inclusive definition of income and in Section 1001(a). That realized gain or loss is taken into account, unless an express nonrecognition provision applies, is codified in Code Section 1001(c) and Treas. Reg. § 1.1002-1(a).

Treas. Reg. § 1.1002-1(c) explains the rationale for statutory nonrecognition provisions as follows:

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[12] One example might be a note in which the parties agree to a minor modification and a new "certificate" incorporating the change is exchanged for the old "certificate." Or perhaps the change is simply written into the old certificate. The language of the Regulation would leave flexibility for finding nonrealization in such cases, which might otherwise be contested. Absent some such flexibility, every modification of an instrument might be held to cause realization of gain or loss—an obviously undesirable and impractical result.

> Exceptions to the general rule [that all gain or loss realized under Code § 1001(a) and (b) is to be recognized under § 1001(c)] are made, for example, by [Code] sections 351(a), 354, 361(a), 371(a)(1), 371 (b)(1), 721, 1031, 1035, and 1036. These sections describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, *but such differences are more formal than substantial*. As to these, the Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated. (emphasis added)

As noted in the Regulation, the statutory nonrecognition provisions apply to exchanges where the differences in exchanged properties are "more formal that substantial." They include for example, the stock exchanged in *Marr*. The explicit premise of the Regulation is that "formal" differences in exchanged properties are sufficient to cause realization, but that a more substantial change in the nature of one's investment is required to cross the higher recognition threshold prescribed in an explicit nonrecognition provision. Where Congress has determined that the lack of substantial "differentness" in exchanged properties does not justify recognition of gain or loss, it has legislated specific nonrecognition provisions that contain more exacting requirements than that required for realization.

This statutory scheme—that gain is recognized from all exchanges, except as otherwise provided—dates from the Revenue Act of 1924. Revenue Act of 1924, ch. 234, § 202(a), 43 Stat. 253. The prior Revenue Act of 1921 provided that gain or loss was not recognized on an exchange unless the property received had a "readily recognizable market value." Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 1560. Because that provision left open the possibility (at least theoretically) that, upon any exchange the taxpayer could claim that gain was not recognized, and the "market value" test could not be applied with consistency, Con-

gress supplanted that provision in 1924 with the predecessor to Section 1001.[13]

The new section provided for "realization" on exchanges to the full extent permissible under the *Eisner* line of cases—which encompasses almost all exchanges. Exemptions from that all inclusive result were then dealt with in specific "nonrecognition" provisions.

Petitioner's reading of the "materially different" phrase in Treas. Reg. § 1.1001-1(a) is plainly inconsistent with this basic structure. It is contradicted by Treas. Reg. § 1.1002-1(b)'s direction that the statutory nonrecognition provisions are to be "strictly construed." Petitioner's reading of the phrase would, in reality, create a new "nonrecognition" section in the guise of a nonrealization rule, and in so doing would carve out of "realization" more than the *Eisner* line of cases requires. An astonishing thing is that petitioner seems oblivious to the fact that while it is dealing here with losses, the opening provided by its rule would permit gains to escape realization as well.

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[13] The House Report on the 1924 Act stated:

> It appears best to provide generally that *gain or loss is recognized from all exchange* and then except specifically and in definite terms those cases of exchange in which it is not desired to tax the gain or allow the loss. This results in definiteness and accuracy and enables a taxpayer to determine prior to the consummation of a given transaction the tax liability that will result therefrom. H. Rep. No. 179, 68th Cong., 1st Sess 13 (1924) (emphasis supplied)

A ruling published by the IRS under the 1934 Revenue Act, when the "materially different" phrase was initially placed in the Regulation, confirms that all exchanges are presumed to give rise to recognized gain or loss. *See* I.T. 2896, XIV-1 C.B. 96 (1935) ("every exchange results in a gain or loss for income tax purposes unless the exchange comes within one of the statutory exceptions.")

D. Petitioner's Position Cannot Be Logically Reconciled with the Two Statutory Nonrecognition Provisions Most Commonly Applied to Exchanges and Would Bar Recognition of Gain or Loss on One of the Most Common Year-End Securities Transactions

Two major "nonrecognition" sections of the Code deal with, and provide nonrecognition for, exchanges of property that is similar in kind. The type of property involved here was deliberately excluded from those provisions. Given the statutory design, the unmistakable implication is that exchanges like the present result in gain or loss that is both realized and recognized.

Section 1031. Since 1921, Congress has provided a specific "nonrecognition" provision, now codified in Code Section 1031, that provides for nonrecognition of gain or loss upon the exchange of property that is "like-kind." Section 1031 expressly excludes from its operation, stocks, bonds and evidences of indebtedness, such as the mortgage loans at issue here. Since mortgage loans would be covered by Section 1031 but for the express exclusion, common sense leads to the conclusion that the exclusion is evidence of Congressional design that gain or loss upon the exchange should be taxed. If there were no "realization"—as petitioner argues—there would be no tax.

The history of the Section 1031 exclusion for stocks, bonds and evidences of indebtedness indicates that Congress created that exclusion deliberately. The exclusion was added to the statute in 1923. §202(c), Act of March 4, 1923, Pub. L. No. 67-545, 42 Stat. 1560 (1923). According to the then Secretary of the Treasury, the exclusion was required because

> [m]any brokers, investment houses and bond houses have established exchange departments and are advertising that they will exchange securities for their customers in such a manner as to result in no taxable gain. Letter from A. W. Mellon to the Hon. William R. Green (Jan 13, 1923), H. Rep. No. 1432, 67th Cong., 4th Sess. 1-2 (1923).

In the 1934 Revenue Act, Congress considered eliminating the entire nonrecognition provision for like-kind exchanges because of alleged abuse. It concluded that the provision should stay, includ-

ing the exception that gain or loss should be recognized on exchanges of notes and securities, because they were "essentially like money."[14]

If petitioner's position were to prevail in this case, taxpayers whose exchanges were deliberately excluded from Section 1031's nonrecognition rule, could structure the exchange to qualify for nonrealization, and the "exchange departments" that Secretary Mellon referred to as flourishing in 1921, and that prompted the exception for stocks, bonds and other indebtedness in 1923, would reemerge. What Congress intended in 1924, and reconfirmed in every Revenue Act and Code thereafter, would be overturned in 1990 by petitioner's new interpretation of an old administrative regulation.

Section 1091. Congressional intent that gains and losses on the exchange of evidences of indebtedness are realized and should be recognized is even more clearly evidenced in Section 1091 of the Code, another "nonrecognition" section. Section 1091 disallows the deduction for (not the "realization" of) losses on so-called "wash sales" of stocks or securities.[15] A wash sale is defined as a sale of a stock or security where a "substantially identical" stock or security is purchased within 30 days before or after the sale. Petitioner agrees that the nonrecognition rule of Section 1091 does not apply to mortgage loans. The fact that it does not apply necessarily implies a Congressional design that losses on wash sales of mortgage loans are to be taxed, even if the loans are "substantially identical."

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[14] The House Report states:

> The law has provided for 12 years that gain or loss is recognized on exchanges of property having a fair market value, such as stocks, bonds, and negotiable instruments; on exchanges of property held primarily for sale; or on exchanges of one kind of property for another kind of property; but not on other exchanges of property solely for property of like kind. In other words, profit or loss is recognized in the case of exchanges of notes or securities, which are essentially like money; . . . H. Rep. No. 704, 73rd Cong., 2d Sess. 13 (1934)

[15] "Securities" are covered by section 1091, but notes and other evidences of indebtedness are not. As the term "securities" is used in the Code, it refers to more formal, long-term, traded instruments.

Petitioner's expansive reading of the "materially different" regulatory phrase would make Section 1091 largely redundant. Section 1091 applies to "substantially identical" stocks or securities. If, as petitioner argues, property that is "substantially identical" cannot be "materially different," Pet. Br. 24-26, then Section 1091 is largely a dead letter, as there would be no "realization", and thus no need for "nonrecognition", of loss on exchanges of substantially identical stocks or securities.[16]

Year-End Securities Loss Transactions. Petitioner's interpretation of the "materially different" phrase is so expansive that it would create a new "wash sale" rule which would deny recognition of losses on stocks and securities that are subject to the wash sale rules of Section 1091, but are not disqualified by that section. The fact that it would do so is additional proof that it is wrong.

Under the "wash sale" rules of Section 1091, stock and security losses are disallowed only if the loss-producing disposition is accompanied by the acquisition of stock or securities that are "substantially identical". The term "substantially identical" for the "wash sale" purposes of Section 1091 is not defined in terms of the "economic position" test espoused by petitioner.[17]

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[16] If non-realization under Treas. Reg. § 1.1001-1(a) were to prevent recognition of loss on such exchanges, then the only function of Section 1091 would be to broaden the number of allegedly separate purchases and sales that are to be treated as exchanges, in cases of loss, by treating all purchases and sales of substantially identical stocks or securities within the section's 61-day time period as exchanges. But if that were Congress' limited intent, it would surely have carried it out in a clearer way. In any event, the legislative history does not reveal any such obscure intent. Further, Section 1091 operates on wash sale losses in a much better fashion than petitioner's proposed non-realization rule would, because Section 1091 provides only for the non-recognition of losses, not gains. Until now, taxpayers have always understood that *gains* on exchanges of even "substantially identical" or not "materially different" stocks and securities are taxable. Petitioner's new proposed rule would necessarily apply to both gains and losses and thus open the door to avoidance of gain on such exchanges.

[17] Treas. Reg. § 1.1233-1(d)(1), promulgated under Section 1233 of the Code and which also looks to whether "substantially identical property" is held, provides an official gloss on the meaning of "substantially identical." It states that for purposes of Section 1233 the phrase has the same meaning as in Section

One of the most common year-end tax planning devices utilized by investors owning depreciated securities who wish to recognize their losses, but not significantly change their economic risk, is to sell the loss stock or securities and immediately reinvest in stock or securities of another issuer in the same industry. As stock or securities of different issuers are universally regarded by taxpayers and the IRS as *not* "substantially identical", these transactions have always been treated as giving rise to recognized gain or loss. Professor Bittker confirms that Section 1091 has never prevented recognition in these transactions and adds that the recognition result is necessary to avoid impossible factual determinations.[18]

While petitioner asserts at one point in its brief that "substantially identical" and "materially different" mean the same thing, Pet. Br. 24-26, it nonetheless argues that different "issuers" or obligors do not make the loans exchanged here "materially different"—even though it is clear that a similar exchange of stock or securities of different issuers would not be "substantially identical" and would result in "realized" and recognized gains and losses under Section 1091.

Petitioners' proposed "change in economic position" standard—as petitioner interprets those words[19]—would cover many

1091, and that "[o]rdinarily stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation."

[18] He states:

> Securities issued by different corporations are rarely substantially identical, even if the two companies are engaged in the same industry and their securities are responsive to the same winds of economic change. While this enables astute investors to sell their depreciated securities at a loss without relinquishing a position in a particular industry or business area, a broader interpretation of "substantially identical," requiring the future internal policies of the two companies to be compared, would invite, if not require, expert testimony between investment counselors that would degenerate into a battle of words about hopelessly imponderable business prospects. 2 B. Bittker & L. Lokken, Federal Taxation of Income, Estates and Gifts ¶ 44.7.3 at 44-105 (2d ed. 1990).

[19] Petitioner's interpretation of those words is a peculiar one, as a change in issuers, provided it is real, invariably changes the holder's "economic position".

stock and securities transactions which have long been treated as "recognition" events. For example, the exchange of securities in one automobile company for securities in another automobile company, or stock of one oil company for stock of another oil company, has never been held to be an exchange of "substantially identical" securities and loss is realized and recognized on such an exchange. Petitioner's new standard for realization could apply to deny realization (and thus recognition) of both loss and gain.

In short, petitioner's arguments simply do not hang together. The arguments hold that "not materially different" and "substantially identical" are synonymous, but then interpret "not materially different" in a manner that would cause common transactions to be "non-recognized" which have been universally treated as "recognized" under the "substantially identical" test. The bottom line is that the loan exchanges involved here are no different from the common year-end stock and securities transactions described.[20]

Conclusions from non-recognition provisions. In two "non-recognition" sections—1031 and 1091—the Code deals specifically with situations in which disposed of property is replaced by similar property. In fashioning those sections Congress deliberately omitted from "non-recognition" treatment transactions like the present loan exchange.

Petitioner confuses change in "present market value" with change in "economic position". See *infra*, pp. 30-31.

[20] Petitioner argues that the Bank Board's finding that the loans are "substantially identical" for its regulatory purpose should be used for federal income tax purposes, even though under applicable federal income tax principles, the loans are not "substantially identical." Petitioner implies that we are dealing only with a factual finding by the Bank Board. But that is not the case. The words "substantially identical" mean something different in the tax law and impose a different standard under which facts are to be tested. The effect of petitioner's argument would be not merely to use regulatory accounting rules to interpret federal income tax rules, but to override federal income tax rules. If "substantially identical" and "not materially different" are synonymous, as petitioner contends Pet. Br. 24-26, then Section 1091's definition of "substantially identical" should be applied here to conclude that these loans are not "substantially identical" and are, therefore, "materially different."

Petitioner's argument is that eight words in an administrative regulation nonetheless confer on the loan exchange the same tax effect it would have if it had been included in those non-recognition Sections. The conclusion proposed defies common sense. If Congress had such an intent in enacting the statute or if the IRS had such an intent in adding the language to the regulations in 1934, they would surely have set forth a rationale to explain why and when "like-kind" or "substantially identical" notes, excepted from the nonrecognition rules of Sections 1031 and 1091, were nevertheless to be swept back into nonrecognition status pursuant to the "materially different" regulatory phrase. There would also have been some explanation of how detailed wash sale rules governing "recognition" of losses with respect to "substantially identical" property can be reconciled with a "realization" standard that is so stringent that it denies realization treatment to exchanges of properties that are not "substantially identical." The inescapable conclusion is that petitioner's new interpretation of Treas. Reg. § 1.1001-1(a) stands contrary to both statutory language and design.[21]

E. Petitioner's Arguments Do Not Undermine the Conclusion that the Mortgage Interests Received Differed Materially from those Exchanged

Although petitioner argues that the loan interests exchanged here were not "materially different", it never articulates a reason for that conclusion which can stand as an objective, neutral

[21] Finally, the Tax Reform Act of 1986 provides additional evidence that petitioner's argument is inconsistent with Congressional design of the Code. Section 56(g)(4)(E) was part of the new alternative minimum tax ("AMT") enacted in 1986. Tax Reform Act of 1986, § 56(g)(4)(E), Pub. L. No. 99-514, 100 Stat. 2332 (1986). A corporation must pay the greater of its regular tax or its AMT. The AMT, in effect, taxes at a lower rate certain items not included in, or used to reduce, regular taxable income. Specifically, Section 56(g)(4)(E) includes in AMT taxable income all losses "recognized on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities." Petitioner's argument is directly contrary to Section 56(g)(4)(E) and, if accepted, would render it a nullity.

principle by which all exchanges can be tested for "material difference".

Petitioner's interpretation of the "material difference" phrase does not rest on statutory language, legal precedent or legislative history. The only proffered sources for its interpretation are dictionaries, which suggest that a "material difference" is a "difference that has the capacity to affect a decision." Pet. Br. 17 n.13. Having offered this definition, petitioner fails to reconcile it with this Court's precedent, which holds that realization occurs upon any exchange of distinct interests in property.[22] Moreover, petitioner fails to explain how so fundamental and heretofore settled a concept as realization can be consistently applied if the "material difference" phrase requires an intensely factual, case-by-case analysis of the conduct and intent of the parties, the pertinent market, the change in economic position of the taxpayer, and the evaluation of any regulatory agency.

Petitioner's principal attack focuses on the conduct and intent of the parties. Specifically, petitioner asserts that respondent did not investigate the risk factors in different loans and then argues that the alleged failure to investigate means that there were no material differences in the loans. The assertion is a *non-sequitur* and distorts the facts. First, whether properties are different depends on the nature of each property, not on the taxpayer's individual perception or investigation of the properties, or on

[22] Petitioner suggests that the overriding test for determining whether exchanged properties are "materially different" is whether the exchange has caused a "change in the taxpayer's economic position." Pet. Br. 15, 19. This verbal formulation, provided one does not impose strange meaning on the words, is consistent with the reasoning in the *Eisner* line of cases. An exchange of different property interests automatically changes a taxpayer's economic position because the taxpayer's economic return is tied to the new property received rather than the old. Moreover, the evidence is clear, not only in respondent's case, but in every case, that an exchange of mortgage loans having different obligors causes a change in economic position because the mortgages and collateral will—as they did in this case—perform differently. As the Tax Court stated in *FNMA*, that is "reality and commonsense." 90 T.C. at 423. Thus, if petitioner's principle is that a change in economic position must arise, or be expected to arise, that test has been met.

valuations by the secondary market in which the properties might be traded.[23] The *Eisner* line of cases makes that clear.

Second, in contrast to the facts envisioned by petitioner, respondent had significant information about the loans received through the Memorandum R-49 criteria. Respondent knew that it was receiving interests in mortgage loans with equal aggregate values to the interests disposed of, but also knew that the different characteristics of the loans assured that different economic consequences would ultimately result. No further investigation would have been cost effective at that point in time, as there was no way to determine, by investigation or otherwise, exactly how differently the new loans would behave from the old loans. Respondent had enough information to decide whether to enter into the transaction.[24]

Next, petitioner suggests that the secondary market treated the differences in exchanged mortgage interests as "economically indistinguishable," and that this factor is important. Pet. Br. 22. In petitioner's view, the only property attributes that are material are those that can be quantified for the purpose of valuing the property at a particular point in time. However, there are many differences in property attributes that, although significant in terms of the economic consequences ultimately flowing from the property, cannot be quantified prospectively in the market place. Market valuation is based on forecasts of the likelihood of future events. It is an exercise in foresight that looks to probabilities. In every exchange of interests in property in an arms-length market,

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[23] For example, in *Marr*, the Court did not consider whether the taxpayer, a shareholder in General Motors, investigated the different risks of owning stock of a Delaware corporation rather than a New Jersey corporation. Whether a taxpayer investigates risks bears no relationship to whether the properties, in fact, have different risks or will perform differently.

[24] The Tax Court recognized this with respect to FNMA, and it is equally true for Respondent:

> In fact, [FNMA] recognized that there were a number of significant differences between the mortgages that made it unlikely that they would behave the same economically. . . . [FNMA] accepted the risk that the mortgages would behave differently economically in order to receive the benefits that it derived from the transactions. 90 T.C. at 412

the aggregate values exchanged will be equal at the time the exchange agreement is struck, even though ultimate subsequent outcomes will almost invariably be different. Petitioner never explains how his market would ever treat property interests with equal values as economically distinguishable. Any market-based inquiry is relevant only to determine values, not which factors are responsible for those values.[25]

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[25] At one point petitioner argues that "[i]tems are fungible if the relevant market treats them as fungible—i.e., if any differences between the items are viewed by the market as wholly inconsequential." Pet. Br. 22. It then concludes that "it is highly significant that in the view of the secondary mortgage market, the differences in the individual loans in this exchange of mortgage pools did not affect their value and hence were not material." Pet. Br. 23. This argument clearly appears to be stating that differences are material only if they affect the market value of the property in question, and that any two objects that have the same market value are fungible and, therefore, not materially different.

The court of appeals in *San Antonio* understood Petitioner's position to be that material difference requires different values. It illustrated that position as follows:

> if two taxpayers exchanged two bonds of different corporate entities engaged in entirely different businesses, but which have the same rating by Moody's, the same interest rate, the same cash flow, and the same value in the capital market, then no change in their economic status would have occurred." 887 F.2d at 590

Petitioner notes this illustration and contends that the court of appeals misstated petitioner's position. Petitioner says the two bonds "have the same value because the market evaluated the various differences between the two companies and the risks associated with those differences, and the resulting valuations happened to coincide." Pet. Br. 23 n.19. Petitioner's response at this point seems directly contradictory to its earlier statements about fungibility generally and wheat, coffee and bonds in particular. Why would not the market evaluate the various differences between different wheats and coffees and conclude, in the case of wheat, that their values just happen to coincide and, in the case of coffees, that they do not coincide because of flavor? More importantly, petitioner presented no evidence and cites no authority as to how it knows—or how a court could determine—how the market operates with respect to wheat, coffee or corporate bonds, or that the value of bonds is determined any differently than the value of mortgage loans. The market may pay as little attention to the identity of the issuer of a fully secured, nondelinquent, AAA-rated corporate bond as it would to the identity of the obligor on a fully secured, nondelinquent residential mortgage loan.

Petitioner's marketplace inquiry test, even if feasible, would completely subvert the certainty that Congress sought in adopting the realization-recognition framework in 1924. A test based on market evaluation would be unworkable because every exchange would require, on a case-by-case basis, the identification of a taxpayer investigation and a relevant market, determination of the property factors considered and not considered by the taxpayer and the market in determining values, and comparison of those factors to objective differences in the properties to see if they match.

To describe such an inquiry is to reject it. The concept of realization is fundamental and pervasive in the Code, which is today published in two volumes, and in Treasury Regulations that require an additional five volumes. There is no neutral or objective way to determine which factors matter to the parties or to the marketplace. The potential effects of petitioner's fuzzy test for such a fundamental principle prove that it cannot have been and was not intended.[26]

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[26] In each of the *Eisner* line of cases, the equivalence of value of securities representing interests in the identical corporate assets (reincorporated in a different state) did not preclude findings that income had been realized. The only two lower court cases cited by petitioner support respondent's position that different legal interests necessarily involve different economic positions. *Emery* v. *Commissioner*, 166 F.2d 27 (2d Cir. 1948), involved the question whether gain was realized when new bonds having a different interest rate, different maturity and different call date were issued to refund old bonds. The court did not engage in any of petitioner's inquiries. Rather, it held that because of the different interest rate, maturity date and call date, the new bonds were "not merely new evidence of an old obligation," but represented a new, different interest. 166 F.2d at 30. The fact that the new bonds were worth less than the old bonds simply corroborated those differences. In *Hanlin* v. *Commissioner*, 38 B.T.A. 811 (1938), aff'd, 108 F.2d 429 (3rd Cir. 1939), the taxpayer reported a loss when it exchanged certain bonds issued by the Federal Land Bank of Louisville for other bonds issued by the Federal Land Banks of St. Louis and Wichita, but having the same value and differing by only six months as to maturity, which was approximately 21 years in the future. The question presented was not whether the loss was "realized," but whether the bonds were "substantially identical" within the meaning of the predecessor provision to Section 1031. The Board of Tax Appeals held that the difference in the obligors of the bonds alone "establishes essential and substantial difference." 38 B.T.A. at 820. The court of appeals concluded that the issuers should be treated as

F. Memorandum R-49's Regulatory Accounting Rule Was Irrelevant to Application of the Code's Income Tax Rule

Finally, petitioner suggests that the loan interests exchanged are not materially different for federal income tax purposes because the Bank Board determined that they were "substantially identical" for regulatory accounting purposes. This argument is equally flawed, for several reasons. First, petitioner says that the Bank Board's conclusion is relevant because the purpose of the materially different requirement for realization is the same as the purpose of the substantially identical requirement in Memorandum R-49: "to ensure that . . . a taxpayer changes his economic position . . . ." Pet. Br. p. 25. Petitioner is wrong on both counts. In the presence of the fact that with any two mortgages, there is always a potential for different performance, the purpose of Memorandum R-49's "substantially identical" requirement was to maximize the probability that the potential for different performance would be modest. In contrast, the purpose of the "materially different" requirement of the *Eisner* line of cases was to ensure only that there *be* a potential for different performance.

In any event, it is wholly irrelevant for tax purposes that the Bank Board applied—briefly—a rule that characterized the mortgage portfolios exchanged as "substantially identical" for regulatory purposes. It is a basic principle of semantics and statutory construction that words may carry entirely different meanings in different contexts.[27] Memorandum R-49, as a Bank Board rule,

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"substantially identical" because each Land Bank was secondarily liable on the obligations of the others, but held that the bonds were not "substantially identical" solely because they were secured by different collateral. 108 F.2d at 431. Thus, even though their equal market values demonstrated that the market could discern no difference in the level of risk associated with the different issues, and that they were, therefore, fungible in the market, the courts focused on the fact that the different legal interests meant different performance could occur, and that was all that mattered. The courts did not inquire as to whether the taxpayer or the market investigated the differences.

[27] The court of appeals clearly recognized this when it held in *San Antonio*:

> The critical consideration is, however, that the "substantially identical" language is employed by [the Bank Board] as an administrative accounting matter to carry out its own regulatory obligations. The "materially differ-

was no more intended to be interpretive, much less dispositive, of federal income tax consequences, than Code provisions and Treasury Regulations are intended to be interpretive or dispositive of regulatory accounting principles.

The ultimate point is that it was the regulators that temporarily departed from traditional regulatory accounting in a regulatory context and for reasons given to advance regulatory purposes. The tax rules remained unchanged.

G. Section 165 Does Not Prohibit Deduction of Respondent's Loss

Petitioner virtually abandons the Sixth Circuit's conclusion that Section 165 disallows deduction of respondent's loss, relegating this position to a footnote that argues that Section 165 simply reiterates the petitioner's realization argument. Section 165 does not serve the same function as Section 1001, and it is not applicable here.

Section 165 serves three purposes. First, it provides for deduction of those losses that do not arise under Section 1001 by reason of a sale or other disposition for consideration, such as theft losses, casualty losses and worthlessness losses. Absent Section 165, such losses would not be deductible. Second, Section 165 restricts deductions for certain types of losses, including wagering losses, theft losses, capital losses, worthless security losses, casualty losses and losses incurred by individuals.

Finally, as petitioner notes, losses that lack economic substance are not deductible under Section 165. The Fifth Circuit, D.C. Circuit and the Tax Court all held that Section 165's reference to losses that lack economic substance does not apply to real economic losses incurred in the ordinary course of business that are fixed by closed and completed transactions. Rather, as those courts held, Section 165 is aimed at sham transactions that are entered into to create artificial losses that would not otherwise

ent" requirement is employed by a different agency, the IRS, in carrying out its separate regulatory responsibilities. Each of these phrases is a regulatory statement created for and used for a different administrative purpose. 887 F.2d at 591

exist. (*San Antonio*, 887 F.2d at 592; *FNMA*, 896 F.2d at 584; *FNMA*, 90 T.C. at 426.)[28]

Section 165 allows a deduction for any loss "sustained." Treas. Reg. § 1.1001-1(a) treats gain or loss realized from a disposition of property as gain or loss "sustained." Since respondent's loss was realized under Section 1001, it was "sustained" for purposes of Section 165.

II. AMOUNTS FORFEITED BY DEPOSITORS UPON EARLY WITHDRAWAL OF THEIR CERTIFICATES OF DEPOSIT WERE INCOME TO RESPONDENT BY REASON OF THE DISCHARGE OF INDEBTEDNESS

A. Satisfaction of a Certificate of Deposit for Less Than Its Face Amount Produces Income "by Reason of" the Discharge of Indebtedness

In *United States* v. *Kirby Lumber*, 284 U.S. 1 (1931), this Court established the principle that a debtor realizes income as a result of the discharge of indebtedness for an amount less than that which is owed. In *Kirby Lumber*, a corporation had purchased some of its bonds on the open market for $137,521.30 less than the amount for which they had been issued. The Court held that the taxpayer's satisfaction of its bonds for less than had been borrowed gave rise to $137,521.30 of income because:

> As a result of its dealings it made available $137,521.30 [of] assets previously offset by the obligation of bonds now extinct. . . . The [taxpayer] has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here. 284 U.S. at 3

This principle is now codified in Section 61(a)(12) of the Code which provides that gross income includes "[i]ncome from discharge of indebtedness."

[28] The cases cited by petitioner, Pet. Br. 16 n. 11, are distinguishable as they did not involve genuine, closed arms-length transactions. *See San Antonio*, 887 F.2d at 592.

The second issue in this case arises because Section 108 of the Code, as in effect in 1981, permitted corporate taxpayers to defer the payment of tax on income realized "by reason of the discharge of indebtedness" by reducing the tax basis of their depreciable assets.[29] Section 108(a)(1)(C) provided:

> Gross income does not include any amount which (but for this subsection) would be includible in gross income *by reason of the discharge* (in whole or in part) of indebtedness of the taxpayer if . . . the indebtedness discharged is qualified business indebtedness." (emphasis supplied)

Both the Fifth Circuit Court of Appeals in this case and the Seventh Circuit Court of Appeals in *Colonial Savings Ass'n* v. *Commissioner*, 854 F.2d 1001 (7th Cir. 1988), cert. denied, 109 S.Ct. 1556 (1989) recognized that the purpose of Section 108 was to alleviate the hardship that would result to a debtor from having to pay tax immediately on discharge of indebtedness income, because the discharge does not itself generate cash with which the debtor can pay the tax.[30]

As stated by the court of appeals below, whether income is realized by reason of the discharge of indebtedness "depends purely on the spread between the amount received by the debtor

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[29] As petitioner notes, tax on income realized by reason of the discharge of indebtedness is not escaped but is, in effect, deferred and collected gradually in future years through lower depreciation deductions or through realization of greater taxable gains upon disposition of reduced-basis assets. Pet. Br. 11. For an example, see Res. Br. in Opp. 26 n.19.

[30] The fact that the discharge never generates cash is true for solvent and insolvent debtors alike. Respondent and petitioner agree that Section 108 applied to any corporation that realized income by reason of the discharge of indebtedness within the reasoning of *Kirby Lumber* and Section 61(a)(12). As petitioner notes, in 1942, Congress settled the matter that all corporations, regardless of their economic condition, were to be eligible to defer recognition of any discharge of indebtedness income. Pet. Br. 30 n.25. Petitioner's suggestion, *see* Pet. Br. 38, that the policy of Section 108 somehow requires inquiring into the solvency of the debtor is an attempt to rewrite legislative history. Even if petitioner were correct that Section 108 applies only where the debtor needs tax relief to strengthen its financial condition, the policy applies here. One need only pick up the daily newspaper to realize that, above all others, the economically battered savings and loan industry needed to strengthen its financial condition.

and the amount paid by him to satisfy his obligation." Pet. App. 12a. That characterization is directly applicable here. Respondent satisfied debts to depositors by paying the depositors an amount less than had been deposited, and the discharge did not generate cash to pay the tax.

The relationship between respondent and the holders of its CDs was solely that of debtor-creditor, and identical to the taxpayer's relationship with its bondholders in *Kirby Lumber*. Upon the early payment of a CD, respondent was in the same position as the taxpayer-debtor in *Kirby Lumber* was upon the early payment of its bonds. Nothing happened in either this case or in *Kirby Lumber*, other than termination of the debtor-creditor relationship upon the debtor's repayment of a lesser amount than had been borrowed. As a result of the debt discharge, an amount of assets equal to the difference between the original deposit liability and the actual cash repaid upon early withdrawal—an amount previously offset by the deposit obligation—was made available to respondent. No cash was generated to pay the tax. Thus, the facts in this case fall squarely within the holding and rationale of *Kirby Lumber* as well as the plain meaning of the statutory language.

Professor Bittker states that income arises "by reason of discharge of indebtedness" when a creditor accepts less in payment because the creditor believes it is in his interest to accept such a financial adjustment:

> The classic case for application of the *Kirby Lumber* principle is a financial adjustment in which a creditor accepts less than the face amount of a debt in full payment, either because of doubts about the debtor's ability to pay in full or because a rise in the interest rate for comparable loans has made the old debt worth less than its face amount. In these circumstances, the creditor attempts to get as much as possible for its claim, while the debtor pursues the corresponding strategy of paying as little as possible. Bittker and Thompson, *supra*, 1174.

The court of appeals noted that one of the reasons for early withdrawal by respondents' depositors may have been that interest rates had risen and more could be earned by depositing the

funds elsewhere,[31] and recognized that "[t]his scenario perfectly fits the classic characterization of debt discharge income." Pet. App. 13a. Still more important, however, is the court of appeals' recognition that even if the withdrawals were made for personal economic reasons:

> the end result was the same; the CD holders withdrew the money because they believed they could put it to better use elsewhere. In turn, Centennial discharged its debt for less than its accrued obligation. *Id*

Income was realized by respondent "*by reason of*" the discharge of indebtedness because, *but for* the discharge, respondent's relationship with the depositor would not itself produce income. The discharge occurred because of the depositor's desire to terminate the debtor-creditor relationship. The depositor could effect such a termination only if it accepted less than the full amount due. Acceptance of less than the full amount due discharged respondent from the full amount, thereby producing income to respondent. That income arose *only by reason of*, and would not have arisen *but for*, the discharge.

B. A Deposit Forfeiture Is Not The Medium of Payment for Income Generated Elsewhere

The case at hand is to be distinguished from situations where a taxpayer would have realized income from some unrelated source, irrespective of the fact that a discharge of indebtedness was also involved. In such situations, the discharge of indebtedness is "incidental" to the production of the income involved. But Section 108 is not available because the taxpayers in these instances do not realize income "*by reason of*" the discharge of indebtedness.

The "by reason of" requirement prevents a debtor from obtaining a tax advantage by using a discharge of indebtedness as the medium of payment of an independent obligation. The requirement is necessary because absent the "by reason of" requirement, a debtor who otherwise did separate business with its

[31] In *Colonial*, the court of appeals noted that the parties in that case agreed that at least 90 percent of the early withdrawals were for this reason. 854 F.2d at 1003.

creditor could seek to avoid immediate taxation on income from that business by arranging with the creditor to apply money owed by the creditor for goods or services to, and thereby discharge, his debt. Although a discharge of indebtedness would have occurred in form, in such situations the purpose of Section 108 would not apply because the debtor could have received cash to pay tax on the income. Absent the "by reason of" requirement, such arrangements would result in the unwarranted deferral of income.

An example of using discharge of indebtedness as a medium of payment is contained in Treas. Reg. § 1.61-12:

> If, for example, an individual performs services for a creditor, who in consideration thereof, cancels the debt, the debtor realizes income in the amount of the debt as compensation for his services.

See also Bittker and Thompson, *supra*, 1174. In the example, the debtor has compensation income. He would have this compensation income whether it was paid in cash, or was paid by being offset against his debt. Thus, the income involved was independent of the discharge of indebtedness; the discharge was simply a "medium of payment" for compensation income.

The distinction between respondent and the debtor in the example is obvious. In all cases in which the depositor holds his certificate to maturity, respondent will not receive any income from the depositor. Respondent realizes income solely by reason of satisfying a liability for less than its full amount—an event that occurs because the depositor chooses to terminate the debtor-creditor relationship before maturity. Since respondent's income would not have arisen "but for" the discharge of indebtedness, it necessarily follows that the income arose "by reason of" the discharge.

This conclusion is also evidenced by the fact that the income realized by respondent is matched by a loss to the depositor. In the compensation example, the creditor suffers no loss. The compensation income is matched by the receipt of services of equal value that, presumably, is reflected in an asset that replaces the account receivable on the creditor's balance sheet.

Characterizing discharge of indebtedness as a "medium of payment" for income is mutually exclusive from characterizing such income as realized "by reason of the discharge of indebtedness." In other words, where debt is discharged for less than face, either income is realized "by reason of" the discharge, or it is not. If it is not, then the discharge is a medium of payment for some other income. Thus, the medium of payment characterization is appropriate when income received *in the form of* discharge of indebtedness is nevertheless not received "*by reason of*" such discharge. The "medium of payment" characterization simply incorporates the thought that income that would be realized by the debtor in any event for reasons independent of the debt, is not to be transformed into income realized "by reason of the discharge of indebtedness" because its delivery and receipt are effected through a cancellation of the debtor's debt obligation. That is not what happened here.

C. Judicial Precedent Establishes that the Medium of Payment Characterization Is Not Applicable to Respondent's Realization of Income by Reason of the Discharge of Indebtedness

Petitioner cites only two cases characterizing a discharge of indebtedness as a medium of payment of other income. Pet. Br. 31. The court of appeals correctly determined that both cases are clearly distinguishable from respondent's discharge of indebtedness.

In each of *Spartan Petroleum Co.* v. *United States*, 437 F. Supp. 733 (D.S.C. 1977), and *OKC Corp.* v. *Commissioner*, 82 T.C. 638 (1984), the taxpayer's outstanding debt was discharged as a means of paying income that would otherwise have been received by the taxpayer. In *Spartan* the debtor became entitled to income in consideration for the cancellation of franchise agreements. In *OKC*, the debtor became entitled to income in consideration for cancellation of an unprofitable output contract. In each case, the creditor's independent obligation to pay income to the debtor arose in the context of a business relationship other than that of debtor-creditor. The creditor's obligation to pay income to the debtor was independent in law and in value from

the taxpayer's obligation to repay a loan. The debtor's income would have been received even if the debt had been paid in cash, rather than in the form of discharge of indebtedness.

The court of appeals recognized that the facts in this case were clearly distinguishable from *Spartan Petroleum* and *OKC*. It concluded that the facts in this case more closely resembled those in *Reliable Incubator & Brooder Co.* v. *Commissioner*, 6 T.C. 919 (1946). *See* Pet. App. 18a.

In *Reliable Incubator*, the taxpayer-debtor had a debt of $6,700 upon which it was obligated to make $50 monthly payments. Because the creditor needed funds, the parties agreed to reduce the outstanding debt by $1,200 in exchange for an advance repayment by the taxpayer of $600. The $600 reduction in the taxpayer's debt was held to be income realized by reason of the discharge of indebtedness, qualifying under Section 108. The court of appeals distinguished *Reliable Incubator* from *Spartan* and *OKC* as follows:

> Thus, two factors distinguish *Reliable Incubator* from *Spartan*. (1) The thing received—faster payment of outstanding debt—was only in the context of the debtor/creditor relationship. In both *Spartan Petroleum* and *OKC Corporation* on the other hand, the debt was cancelled as payment for an entirely different item or right of material worth outside the debtor/creditor relationship. (2) In *Reliable Incubator*, after all the dust had settled, the creditor did not get the full value of the loan back, whereas in *OKC* and *Spartan* they did. Pet. App. 18a.

In sum, the court of appeals in this case correctly determined that debt discharge is not a medium of payment for other income where the debt discharge arises as an *integral*, not *incidental*, part of the debtor-creditor relationship:

> We cannot accept the government's claim that the CD penalty was a separate obligation, independent from the debtor/creditor relationship existing between the bank and the depositor. The penalty was not assessed as the result of a separate relationship. It was an integral part of the CD arrangement, a requirement delineated prior to the purchase of [the] CD. No separate contract created the CD penalty,

and in fact the penalty was an integral part of the CD obligation. Pet. App. 19a-20a.[32]

As the court of appeals held, respondent is just like the debtor in *Reliable Incubator*. In both cases, the creditor had requested that his loan be repaid early. In both cases, the creditor is required to accept a discount for early payment. The only difference between respondent and the debtor in *Reliable Incubator* is that, in respondent's case, the amount of the discount to be taken in the event of early withdrawal was fixed in advance.

[32] Characterizing a discharge of indebtedness as being "integral" or "incidental" to the debtor-creditor relationship produces the same result as a "but for" test used here by respondent. If income would not be realized "but for" the discharge, the income is "integral" to the debtor-creditor relationship and, therefore, arises "by reason of the discharge." If the discharge is "incidental" to that relationship, the discharge is simply a medium for payment of other income. This "integral-incidental" analytical framework is used in the Treasury Regulations in other situations where the tax treatment of the transaction depends not just on the formal relationship between parties, but on the nature of the economic relationship inherent in a particular transaction. For example, Section 311 of the Code, as in effect prior to 1986, provided that a corporation did not recognize income upon the distribution of property in redemption of its stock. Treas. Reg. § 1.311-1(e) qualified this nonrecognition rule by an identical "medium of payment" exception that expressly limited the nonrecognition to distributions "made by reason of the corporation-stockholder relationship," and expressly denied nonrecognition to "transactions between a corporation and a shareholder in his capacity as debtor, creditor, employee or vendee, where the fact that such debtor, creditor, employee or vendee is a shareholder is *incidental* to the transaction." (emphasis added). The medium of payment exception to Section 108 should be given a construction similar to Treas. Reg. § 1.311-1(e). The medium of payment characterization is apt only where the creditor's payment of its obligation through reduction of indebtedness due it is incidental to its status as a creditor, and not integral to the debtor's repayment of its principal. Here, the depositor's payment of its obligation (assuming, *arguendo*, that it is appropriate to think of the agreed reduction in the amount owing the depositor as an "obligation" of the depositor) is integral to and derives from respondent's repayment of principal.

D. A Forfeiture Constitutes Income by Reason of Discharge of Indebtedness Notwithstanding that the Amount of Forfeiture Was Fixed in Advance

Petitioner argues that the early discharge of a CD constituted a "medium of payment" for a separate "obligation." A moment's reflection leads to the realization that petitioner's entire argument rests on the fact that the amount of income realizable by reason of an early discharge was determined here under a formula agreed to in advance. If the amount were negotiated at the time of withdrawal, the same *quid-pro-quo* would exist but the artificiality of arguing that the amount satisfied a separate "obligation" would be unmistakable.

Petitioner cites no authority to support the argument that the advance fixing of the amount of forfeiture causes the discount not to be income "by reason of" the discharge of indebtedness. The only authority is to the contrary. *See Columbia Gas System, Inc.* v. *United States*, 473 F.2d 1244 (2d Cir. 1973).[33] *Accord*: *Bethlehem Steel Corp.* v. *United States*, 434 F.2d 1357 (Ct. Cl. 1970).

That the amount of debt to be forfeited upon premature termination of a debtor-creditor relationship is arranged in advance does not change the fact that, upon such termination, the debtor receives income "by reason of" the discharge of indebtedness, because, but for the discharge of the indebtedness at less than its full amount, the debtor would not have had income.

[33] In *Columbia Gas* the taxpayer had issued debentures convertible into common stock. The debentures expressly provided that "[n]o adjustment is to be made on conversion for interest accrued hereon. . . ." 473 F2d at 1246. In other words, conversion resulted in a discharge of the taxpayer's obligation to pay accrued interest to the debenture holder. The Second Circuit Court of Appeals affirmed the District Court's adoption of the IRS's view that interest not taken into account upon conversion constituted income by reason of the discharge of indebtedness. Respondent is in exactly the same position as the taxpayer in *Columbia Gas*. In both cases, the creditor knew that if it did not hold the debt instrument to maturity, it would not be paid the entire amount owed to it, the difference being measured by a standard agreed to in advance. In *Columbia Gas*, the creditor chose to forego a part of the amount owed in order to receive the remainder to invest in stock. Here, the depositor chose to forego a part of the amount owed in order to receive the remainder to invest elsewhere.

Section 108 nowhere states that income realized upon premature payment of a debt for less than face can only be "by reason of the discharge" if the discount is determined through contemporaneous negotiation. To impose such a limitation would be legal policy at its worst because it would serve only to punish those parties who wish to anticipate potential future events and resolve them in advance. The Code, as all law, should encourage parties to resolve uncertainties in advance and thereby minimize conflict, not require them to wait until a conflict arises and one party is in an economically stronger position than the other.

Petitioner's characterization of the discharge as a penalty paid to respondent fixed by federal regulations, is simply a variation of the argument that the amount of the forfeiture was fixed in advance. Even as a factual matter, however, it is not an accurate characterization. There was no obligation anywhere for the depositor to "pay" anything, but only provision for reduction of the deposit that could be withdrawn. In addition, the reduction was not fixed by the federal regulation, which only required that the S&L set a formula reduction with a prescribed minimum. The formula reduction fixed by respondent was different from, and greater than, that set forth in the regulation.[34]

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[34] A review of the applicable federal regulation 12 C.F.R. § 1204.103 (1981), reveals that it did not require the depositor to "pay" anything to the financial institution. To the contrary, the federal regulation required financial institutions like respondent to *repay less* than had been borrowed from depositors. The regulation provided that where a certificate is "paid before maturity, *a depositor shall forfeit* an amount at least equal to . . . ." (emphasis added). Similarly, respondent's certificate of deposit contracts prescribed forfeitures of specific amounts by depositors. (J.A. 27-29) In fact, the contracts provided for a higher forfeiture than the minimum set in the regulation. As petitioner notes, prior regulations applicable to accounts opened or renewed before June 2, 1980, described the forfeiture as the payment of a "penalty." Pet. Br. 32. However, there is no suggestion that the penalty was an independently enforceable obligation apart from the early discharge of the certificate of deposit. The record does not reveal how much of the amount in issue in 1981 was attributable to the earlier certificate accounts. It is doubtful that much, if any, of the amount in issue for 1981 is attributable to such accounts because respondent's certificate contracts required a forfeiture of all interest earned in the event of early withdrawal. On older accounts, that would be a substantial amount and act as a deterrent to early termination. In any event, the revision of the language in the 1981 regulations clarifies that even the regulators recognized that the penalty characterization was a misnomer and that, in substance, the regulation was effecting a reduction of indebtedness.

Furthermore, characterization of the forfeiture as the payment of a penalty has no relevance to whether income realized is "by reason of" the discharge of indebtedness. As noted by the court of appeals, "[a]ny pure debt discharge transaction could be characterized as taking two steps" Pet. App. 22a—i.e., as a first-step "obligation" of the creditor to pay the full amount, and a countervailing second-step "obligation" of the creditor to pay an amount in exchange for being paid the full principal. If the depositor's forfeiture were recharacterized in this case as the payment of a separate penalty obligation by the depositor, then the forfeitures in *Reliable Incubator* and *Kirby Lumber* must be similarly recharacterized. In those cases, the creditors were equally penalized by a discharge of a portion of the debt in return for the early return of their funds.[35] In none of the cases was the creditor obligated to pay an independently determined amount to the debtor.[36]

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[35] Petitioner's argument that the portion of the debt not repaid was not "forgiven" by the depositor but was used to satisfy a penalty obligation, Pet. Br. 34-35, necessarily implies that a creditor must "forgive" debt without consideration in order for a reduction in the amount of principal to be repaid to constitute discharge of indebtedness income. In *Commissioner* v. *Jacobson*, 336 U.S. 28 (1949), this Court rejected the theory that, in a commercial context, debt is forgiven without consideration. The court recognized that, at least in the commercial context, where a creditor accepts less of its principal than it lent, the creditor "got all that he could." 336 U.S. at 50. So here. A depositor who desired early withdrawal of principal "got all that [it] could," by agreeing to a return of less principal than it had lent. This is the essence of discharge of indebtedness.

[36] Petitioner's attempt to characterize the discharge of indebtedness in this case as a medium of payment for other income would swallow up the entire discharge of indebtedness rule. By definition, whenever debt is discharged before term for less than the amount borrowed, the creditor always suffers a "penalty" in that he receives back less than he lent. But such an economic cost is incurred by a creditor only because the debtor-creditor relationship is terminated and a portion of the debt is discharged without payment. The forfeiture is the *quid pro quo* for the early termination. If the relationship were not terminated, there would be no penalty and no separate obligation of the creditor to pay. Accordingly, petitioner's theory that a forfeiture of debt that is integral to the debtor-

Finally, petitioner fails to explain why the existence of a federal regulatory policy *per se* causes early withdrawal forfeitures to be separate obligations from the discharge of a financial institution's indebtedness. The court of appeals deemed the fact that a regulation imposed the penalty to be "inconsequential." The only reason petitioner advances is the question-begging conclusion that "[s]urely, however, that fact is of significance to whether the early withdrawal penalty represents a separate obligation, or simply the debtor's discharge of indebtedness." Pet. Br. 34.

The federal regulations do not require forfeitures outside the debtor-creditor relationship. To the contrary, the federal regulations bespeak a policy of stabilizing debtor-creditor relationships in a rising interest rate environment that puts enormous competitive pressures on savings and loans and other financial institutions, and also presents a classic case for unregulated debtors and creditors to negotiate discharge of indebtedness. The federal regulation's minimum forfeiture is simply the government's attempt to regulate the market for discharge of indebtedness.

Overall, petitioner's focus is on irrelevancies. Distinctions based on such factors as whether the amount of debt forfeiture is set in advance or negotiated later, whether the forfeiture is called a "penalty" or bears some other label, or whether the forfeiture amount is subject to regulation, do not address the question of whether income arose "by reason of" the discharge of indebtedness. Regardless of the factors discussed by petitioner, there can be no dispute that respondent would not have realized income *but for* the discharge of indebtedness. The discharge was not a "medium of payment" for another obligation of respondent.

E. The Internal Revenue Service's Published Rulings Support Respondent's Position that Section 108 Is Applicable in this Case

Petitioner argues that its position is "buttressed by the Commissioner's analysis of the tax consequences for the depositor [in Revenue Ruling 73-511, 1973-2 C.B. 402] and by Congress' reaction to that analysis." Pet. Br. 35-36. Rather than support the

creditor relationship is a medium of payment for a separate penalty obligation would logically render Sections 61(a)(12) and 108 of the Code nugatory.

petitioner's argument that a forfeiture upon early withdrawal of a CD constitutes a separate obligation of the depositor, independent of the debtor-creditor relationship, the ruling's holding and analysis support the conclusion that the forfeiture creates income by reason of the discharge of indebtedness.

Revenue Ruling 73-511 addressed the issue of whether the amount of interest paid or credited by a financial institution to holders of CDs was gross or net of any forfeitures incurred by the holders upon early withdrawal. In the ruling, as in this case, the CD contracts provided that interest was credited to depositors upon prescribed dates (quarterly, semiannually, or annually) and became withdrawable without penalty. The forfeiture upon early withdrawal of principal was calculated by reference to actual interest earned or that could have been earned for specified periods. The ruling held that, because a depositor had the right to withdraw accrued interest in full immediately upon its being credited, interest was constructively received when credited and the financial institution was obligated to report the full amount of interest credited, without any netting for subsequent forfeitures.

In effect, Revenue Ruling 73-511 held that a premature withdrawal forfeiture was not a discharge of the interest, but was a discharge of the principal. Tax consequences would not turn on whether the amount of the forfeiture happened to be calculated under a formula that referred expressly to principal, to interest or to both. This result is straightforward and sensible.

The ruling treats the forfeiture as a transaction separate from the payment or crediting of interest. Thus, the forfeiture did not affect either the amount of interest reported by the financial institution or the amount of interest included in the depositor's gross income. Consistent with these holdings, the ruling also held that a depositor could deduct the forfeiture as a loss incurred in a transaction entered into for profit under Code Section 165(c)(2).[37]

[37] As petitioner notes, Pet. Br. 36, a consequence of this holding was that only individuals who itemized their deductions could obtain a tax benefit for the forfeiture, and Congress subsequently made the loss an adjustment to gross income so as to be available to nonitemizers.

Petitioner argues that the fact that the IRS deemed the crediting of interest and the forfeiture upon early withdrawal to be separate transactions means that the forfeiture was a separate obligation from the financial institution's indebtedness. This is a *non sequitur*. That ruling was simply a clear-cut recognition that interest and principal of a debt are treated separately for tax purposes. This separate treatment does not prove that the forfeiture itself is a separate and independent obligation from the financial institution's obligation to repay principal. In fact, the forfeiture is the method by which the discharge of the principal of the debt is accomplished.

The ruling's treatment of the forfeiture as a loss from an investment under Section 165(c)(2) effectively repudiates petitioner's characterization of the forfeiture as the medium for payment of a separate obligation. Were the forfeiture merely a medium for payment of a separate obligation, it would be deductible under a different Code section. The Code provides for the deduction of expenses separately from the deduction of losses. Trade or business expenses, including penalties, are deductible, if at all, under Section 162(a), subject to the limitation in Section 162(f) regarding penalties paid to a government. Penalties and other expenses of satisfying obligations are not deductible as losses under Section 165. Investment expenses for the production of income are deductible under Section 212, but not under Section 165.

Treatment of the forfeiture as a Section 165 loss, rather than as a Section 162 trade or business expense or Section 212 investment expense, recognizes that a portion of the depositor's investment has been lost. The only investment a depositor had was the principal amount it lent the financial institution. Thus, Revenue Ruling 73-511's treatment of the forfeiture as a loss of principal by the depositor is tantamount to treatment of the forfeiture as the discharge of the same principal amount owed by the financial institution. The loss is the consequence to the depositor of the discharge of respondent's indebtedness. Thus if Congress' legislative reaction to Revenue Ruling 73-511 is of any relevance, it affirmed the longstanding treatment of a reduction in principal amount of a debt as discharge of indebtedness income.

CONCLUSION

The judgment of the court of appeals should be affirmed. Respectfully submitted.[39]

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[39] The Acting Solicitor General has authorized the filing of this brief.

REPLY

BRIEF

(10)

No. 89-1926

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In the Supreme Court of the United States

OCTOBER TERM, 1990

UNITED STATES OF AMERICA, PETITIONER

v.

CENTENNIAL SAVINGS BANK FSB
(RESOLUTION TRUST CORPORATION, RECEIVER)

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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REPLY BRIEF FOR THE UNITED STATES

1. The purpose of the longstanding "materially different" requirement in the Treasury Regulations is to prevent the realization of gain or loss on economically meaningless exchanges that do not change the taxpayer's economic position. The swap of mortgage pools that respondent engaged in was precisely tailored to ensure that it would "not change the economic position of the association after it engaged in the swap." J.A. 58 (Bank Board memorandum). Respondent satisfied (through a computer match) the criteria of Memorandum R-49, and thus did "not change [its] economic position." Respondent then turned around and tried to deduct a $2.8 million loss on the ground that the "substantially identical" mortgage pools (J.A. 55) were actually "materially different." Respondent's position thus rests on an "inherent contradic-

tion" (*Portland Golf Club* v. *Commissioner*, 110 S. Ct. 2780, 2789 (1990)); it should not be permitted "to have its cake and to eat it too." *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 546 (1979).

The only way in which respondent can at once satisfy the "substantially identical" test of Memorandum R-49 and the "materially different" requirement of Treas. Reg. § 1.1001-1(a) is to read the word "materially" out of the Regulation. Under respondent's test, the Regulation is satisfied whenever "an interest in property [is] exchanged for a different interest in property." Resp. Br. 20.[1] The problem with this proposed definition is obvious. In essence, respondent contends that property is *materially* different if it is *different*. In the absence of a *materially* different requirement, however, economically meaningless exchanges of property—such as 1000 bushels of Kansas wheat for a "different" 1000 bushels of Kansas wheat—would constitute realization events and produce tax consequences. The end result, as we explain in our *Cottage* brief (at 14), would be effective nullification of the realization requirement for losses.[2]

Indeed, in our view, respondent all but gives up the game when it acknowledges that there should be "flexibility for finding nonrealization" in the case of an exchange of an old certificate for a new one with a "minor modification," and that a contrary rule would be "an obviously undesirable and impractical result." Br. 20 n.12. We agree; the whole purpose of the "materially different" requirement in the Regulation is to determine when a modification is "minor," and the flexibility respondent

[1] See also Resp. Br. 18 ("[T]he threshold for realization * * * is crossed whenever an interest in property is exchanged for an interest in other legally distinct property.").

[2] Many of respondent's arguments were also raised by the petitioner in *Cottage*, and are addressed in our *Cottage* brief. A copy of that brief has been supplied to respondent's counsel.

finds desirable is the *Commissioner's* in promulgating and applying his Regulation.[3]

2. Respondent relies on several of this Court's decisions from the early 1920s for the proposition that any exchange of property for different property is a realization event. Br. 12-16. The cases do not establish that proposition, and, in any event, did not purport to establish the parameters for realization in all contexts.

In both *Eisner* v. *Macomber*, 252 U.S. 189 (1920) and *Weiss* v. *Stearn*, 265 U.S. 242 (1924), the taxpayers ended up with something *different* from what they had before: additional shares of stock in *Macomber* and shares in a new corporation in *Weiss*. Because the differences "add[ed] nothing to [the property] of the shareholder" in *Macomber*

[3] Respondent's amici take varying approaches to the "materially different" requirement. Amicus Federal National Mortgage Association (FNMA) contends (Br. 10) that the requirement is satisfied if "the exchanged assets represent different property rights." Like respondent's argument, this contention strips the concept of materiality of any meaning. Amicus U.S. League of Savings Institutions acknowledges that the materially different requirement "has become the touchstone for identifying a realization of gain or loss" (Br. 7), but asserts that the requirement is "a relic of earlier times" (*id.* at 11) that has "outlived its usefulness" (*id.* at 24). Amici Main Line Federal Savings Bank, et al., similarly contend (Br. 5 n.4), as one of their arguments, that the regulation should be invalidated. As we explain in our *Cottage* brief (at 14-15), there is no basis for invalidating the materially different aspect of the realization requirement.

Notably, at various points, respondent's amici acknowledge that exchanged properties must differ in *some* respect before an exchange can be a realization event. See, *e.g.*, U.S. League Br. 3 (realization occurs "unless the properties exchanged are *so similar* that they represent the identical property rights") (emphasis added); Main Line, et al. Br. 3 ("The proper test [under the regulation] * * * is whether [properties] are *inherently different* from each other.") (emphasis added); FNMA Br. 7 (no realization if exchange is "*so devoid* of a change *in substance* that no disposition of property * * * has *really* occurred") (emphasis added). Yet once it is recognized that there is *some* requirement that the exchanged properties differ, the precise definition of that requirement should be left to the Commissioner.

(252 U.S. at 212) and did not "give[] the stockholder a thing really different from what he theretofore had" in *Weiss* (265 U.S. at 254), however, this Court held that there was no realization. In contrast, in *Marr* v. *United States*, 268 U.S. 536 (1925), the Court held that a taxpayer who received stock in a new corporation in exchange for stock in the old realized a gain on the exchange, because the old and new corporations were "*essentially* different." *Id.* at 541 (emphasis added). See Gov't *Cottage* Br. 22-23 (discussing *Marr*). Indeed, the discussion in *Marr* of *Weiss* highlights this point. In *Marr*, the Court recognized that the old and new corporations involved in the *Weiss* exchange were different: "Technically there was a new entity; but the corporate identity was deemed to have been substantially maintained because the new corporation was organized under the laws of the same State, with presumably the same powers as the old." *Marr*, 268 U.S. at 541. Since the corporate identity was substantially maintained, the old and new corporations in *Weiss* were different, but not essentially different. See Gov't *Cottage* Br. 22 (discussing *Weiss*).

These cases thus establish that a mere difference is not enough to establish realization from an exchange; the properties transferred must instead be "really different" or "essentially different." This teaching is of course entirely consistent with the Commissioner's promulgation of the "materially different" requirement in the Regulations.[4] At the same time, the fact that there was no

[4] Respondent also relies (Br. 13-16) on three other early tax decisions in which this Court held, as it did in *Marr*, that a shareholder realized income upon the receipt of shares in a corporate reorganization. *Cullinan* v. *Walker*, 262 U.S. 134 (1923); *United States* v. *Phellis*, 257 U.S. 156 (1921); *Rockefeller* v. *United States*, 257 U.S. 176 (1921). In those three cases, the shareholders were taxed "on the ground that they received securities in an essentially different corporation having essentially different characteristics." 3 M. Weinstein, *Mertens Law of Federal Income Taxation* § 20.02, at 20 (rev. 1990). Accordingly, the Fifth Circuit correctly held in *San Antonio Savings Ass'n* v. *Commissioner*, 887 F.2d 577, 585 (1989), petition for cert. pending, No. 89-1928, that "*Phellis*, *Rockefeller*, and *Cullinan* do not establish that an exchange of items which differ from each other only formally nevertheless constitutes a realization event."

realization on the facts of *Macomber* and *Weiss* hardly means that there will always be realization unless the facts presented parallel the facts of those two cases.

In any event, respondent is wrong to view those 1920s cases as the beginning and end of the inquiry. The question is *not*, as respondent would have it, whether the differences in the swapped mortgage pools were sufficient "to cause gain or loss to be realized under the *Eisner* line of cases." Br. 17. Rather, the question is whether the differences satisfied the "materially different" requirement *in the Regulation*. By focusing exclusively on the cases, respondent seeks to read out of this case the deference this Court has held is due the Commissioner in promulgating Treasury Regulations, see, *e.g.*, *Thor Power Tool*, 439 U.S. at 533 n.11 ("it is well established, of course, that [Treasury Regulations] 'must be sustained unless unreasonable and plainly inconsistent with the revenue statutes' and 'should not be overruled except for weighty reasons' ") and in interpreting those Regulations, see, *e.g.*, *Robertson* v. *Methow Valley Citizens Council*, 109 S. Ct. 1835, 1850 (1989) (agency interpretation of own regulation is "controlling" unless it is "plainly erroneous or inconsistent with the regulation").

Macomber, *Weiss*, and *Marr* arose, in part, from taxpayers' constitutional objections that certain transactions did not produce "income" within the meaning of the Sixteenth Amendment.[5] Even if the Commissioner's interpretation of the "materially different" requirement in the Regulation establishes a more rigorous test for realization than the constitutional test in the 1920s cases (a proposition we dispute), nothing in those decisions pre-

[5] See, *e.g.*, *Marr*, 268 U.S. at 539-540; *Weiss*, 265 U.S. at 253-254; *Eisner* v. *Macomber*, 252 U.S. at 199. See generally 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 5.1 (2d ed. 1990).

cludes a more rigorous test. Indeed, far from claiming that the Commissioner's interpretation somehow implicates Sixteenth Amendment concerns in this case, respondent repeatedly objects that the Commissioner's interpretation will allow income of other taxpayers to *escape* taxation (Br. 7, 16, 22)—precisely the opposite of the taxpayers' claims in the early cases. Those cases clearly did not permanently tie the Commissioner's hands and prevent him from refining and clarifying the materially different requirement through promulgating and applying a Treasury Regulation; that is why we have such regulations in the first place. Thus, even if respondent's premise were correct (that the Commissioner's interpretation goes beyond the 1920s cases), respondent's corollary (that the Commissioner has no discretion to do so) is incorrect.[6]

3. Respondent also maintains that its proposed definition is compelled by the nonrecognition provisions of Sections 1031 and 1091. That respondent's mortgage swap transactions did not fall within the specific non*recognition* provisions of Section 1031 (which governs "like kind" exchanges) and Section 1091 (which governs "wash sales" of stock or securities) does not mean that a loss was *realized* on the transactions. Contrary to respondent's argument, the Commissioner's interpretation of the "materially different" requirement for realization on exchanges in no way renders Sections 1031 and 1091 superfluous, since property of "like kind" is a much broader concept than property that is not materially different,

[6] Respondent's statement (at 9, 19) that we conceded that the Treasury Regulation merely codifies earlier cases is incorrect. See Gov't Br. 15 n.10. Although, as we have noted (Br. 13 n.9), the enactment of the predecessor to Section 1001 was not intended to change the law, nothing in that Act or its successors precludes the usual discretion accorded an agency charged with interpreting and administering a statutory regime. In fact, the Code has always conferred on the Secretary of the Treasury the authority to issue regulations needful for the enforcement of the Code. See I.R.C. § 7805.

and the "wash sale" rule applies regardless of whether the transaction can be characterized as an exchange. Like the petitioner in *Cottage*, respondent confuses the entirely distinct principles of *realization* and *recognition*. The fact that Congress elected to provide for nonrecognition in the situations covered by these Sections in no way suggests a determination that there must be realization in all other situations. See Gov't *Cottage* Br. 24-28.[7]

4. Respondent also claims that the Commissioner's interpretation is "incapable of effective administration" (Br. 20) and that its proposed test is more desirable "[f]rom a tax administration point of view" and "[f]rom a revenue point of view" (*id.* at 16). The Commissioner—charged by law with interpreting and administering the Internal Revenue Code, and entrusted with administrative discretion to discharge that responsibility—disagrees. See *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 476-477 (1979); *United States* v. *Correll*, 389 U.S. 299, 305-307 (1967). Indeed, the real threat to proper administration of the Internal Revenue Code would come from respondent's test, which would attribute tax consequences to meaningless exchanges, such as in the bushels of wheat example. Contrary to respondent's contention, the Regulation's "materially different" test is not too high a hurdle. The lengths to which respondent and its trading partner went in matching their swapped loans,

[7] Respondent also relies (Br. 20-21) on Treas. Reg. § 1.1002-1(c), which states that certain nonrecognition provisions of the Code apply to exchanges in which "differences [in the exchanged properties] are more formal than substantial." Respondent's contention that this statement in the Regulation establishes a general rule that "'formal' differences in exchanged properties are sufficient to cause realization" (Br. 21) is plainly incorrect. The Regulation is referring specifically to the nonrecognition provisions, not to the realization requirement, and the differences between the scope of the nonrecognition provisions and the realization requirement are readily apparent. See Gov't *Cottage* Br. 25-26.

see J.A. 55-56 (10 criteria for match), provide a good example of what it takes to fail the test.[8]

5. We demonstrate in our opening brief (at 17-26) that the available evidence from (1) the conduct and intent of the parties, (2) the evaluation of the pertinent market (the secondary mortgage market), and (3) the determination of the agency charged with regulating federal savings and loan associations (the Bank Board), confirms that such differences as there were in the mortgage pools exchanged here were not material. Rejecting all of these sources of evidence, respondent instead would look to "the nature of each property." Resp. Br. 29. Such an inquiry, however, is really nothing more than a conclusion derived from consideration of the very factors respondent eschews. Two shares of stock of the same class in the same corporation are different in that they have different serial numbers, but that difference is not material. Why not? Because parties dealing in stock, and the market for stock, simply do not care what the serial numbers happen to be. If the parties and the market *did* care—for example, if the stock at issue consisted of antique shares whose value derived from the certificate itself and not the ownership interest it represented —then the different serial numbers *would* constitute a material difference. Nothing about "the nature" of serial numbers on stock answers the question whether the differences are material—you need to know, *inter alia*, how the parties and the market regard such differences. That is not a "subjective" test; it simply recognizes that pertinent evidence, rather than preconceived notions about

[8] Notably, in contrast to respondent's repeated statement that it is "astonishing" that the realization effect of its exchange might be questioned (Br. 7, 22), the exchanges were apparently structured and initially defended as reciprocal sales in an effort to avoid the materially different inquiry for exchanges altogether. See Pet. App. 3a, 44a-47a; *San Antonio Savings Ass'n* v. *Commissioner*, 887 F.2d 577, 581 (5th Cir. 1989), petition for cert. pending, No. 89-1928.

the abstract "nature" of property, needs to be considered before arriving at an objective conclusion.[9]

In the alternative, respondent also contends (at 30) that it had "sufficient information about the loans received" and "knew that the different characteristics of the loans assured that different economic consequences would ultimately result." Respondent ignores the fact that the district court specifically considered respondent's claimed awareness of general differences in the loan packages and determined that those claimed general differences were immaterial. See Pet. App. 39a, 52a; Gov't Br. 20 n.17.

With regard to the evaluation of the pertinent market, respondent does not dispute the factual findings that the differences in the mortgage pools were immaterial to the secondary mortgage market. See Pet. App. 52a-53a; see also Gov't Br. 21-22. Instead, respondent maintains that the evaluation of the pertinent market is irrelevant because a "market-based inquiry is relevant only to determine values, not which factors are responsible for those values." Resp. Br. 31. As we have explained (Br. 22-23; *Cottage* Br. 32), there is a fundamental difference between the concept of equivalent value and the concept of

[9] Indeed, amicus FNMA concedes that "whether the differences mattered to the parties to the transaction may be of some relevance in determining whether they matter in general." Br. 21.

FNMA also advances the novel suggestion that this case be decided on the record in a different case, rather than the record in the case before the Court. Br. 12. The facts regarding the swap transactions in this case, of course, were fully considered and addressed by the district court. The court of appeals viewed most of the facts as legally irrelevant, but that erroneous legal conclusion does not require borrowing the record and facts from a different case. We strongly disagree with FNMA's suggestion that the record in its case establishes a material difference, but those contentions can be addressed in the context of that case. Far from being representative, moreover, FNMA is unlike other financial institutions in many respects, including the fact that it was not even subject to Bank Board regulation. See *Federal National Mortgage Ass'n* v. *Commissioner*, 896 F.2d 580, 582 (D.C. Cir. 1990), petition for cert. pending, No. 89-1987.

material difference, and the evaluation of the pertinent market can be quite helpful in considering whether the differences are material even if the market (and the parties) assign the properties equivalent value. Respondent's suggestion that the market perspective is incapable of determination, moreover, ignores the fact that the issue was vigorously litigated in this very case, and the district court simply resolved the issue against respondent. Pet. App. 52a-53a. As the district court's findings confirm, the issue is fully capable of resolution, and the market perspective provides probative evidence of the nature of the exchange.

Respondent successfully demolishes a series of straw men of its own creation. It argues that the Commissioner's position would lead to a finding of no realization on "the exchange of securities in one automobile company for securities in another automobile company, or stock of one oil company for stock of another oil company," or one AAA-rated corporate bond for an AAA-rated bond of a different corporation. Resp. Br. 27, 31 n.25. Of course not. Certainly the "materially different" requirement demands the drawing of lines, but that is true throughout the Internal Revenue Code and law in general. Saying that there is no material difference between computer-matched pools of mortgages of the same type, secured by single-family residences, in the same state, with the same interest rate, same stated terms to maturity, and similar remaining terms to maturity, principal amounts, fair market values, and loan-to-value ratios, swapped without recourse (see J.A. 55-56), is not the same as saying there is no material difference between Ford and GM stock, Mobil and Exxon stock, or Union Pacific and Southern Pacific bonds. The parties and the market tell the tale: an investor giving up his GM stock would care to know whether he was getting Ford or Chrysler stock in return; here, once the pools of mortgages were matched according to the rigorous R-49 criteria, respondent did not care whether John Doe or Tom Roe was the original borrower on one of the

loans; indeed, respondent did not even obtain files showing who the borrowers were until six years after the swap, and the information was not even available at the time of the swap. Pet. App. 36a n.5.[10]

Respondent likewise rejects the Bank Board's evaluation of the mortgage pools at issue as "wholly irrelevant for tax purposes." Br. 33. According to respondent, the Bank Board's determination should be disregarded because it represents a "depart[ure] from traditional regulatory accounting." *Id.* at 34. As we explain in our opening brief (at 25-26), it is not the Bank Board's conclusion that no loss on an R-49 transaction need be reported for regulatory accounting purposes that is significant here; rather, it is the Bank Board's expert conclusion that loans meeting the R-49 criteria are "substantially identical" (J.A. 55) and that a swap of such loans would "not change the economic position of the association after it engaged in the swap" (J.A. 58). Together with the conduct and intent of the parties and the evaluation of the market, the Bank Board's evaluation establishes that the differences in the loan pools were not material.[11]

Having rejected the relevance of the conduct and intent of the parties, the market perspective, and the expert agency's conclusion, respondent, like petitioner in

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[10] Thus, respondent is plainly wrong in asserting that it "did no more" than investors who dispose of devalued stocks and reinvest the proceeds in similar stocks of different issuers. Br. 3, 27.

[11] In its effort to minimize the significance of the Bank Board's determination, respondent seeks to recharacterize the Bank Board's analysis. According to respondent, "the purpose of Memorandum R-49's 'substantially identical' requirement" was simply "to maximize the probability that the potential for different performances would be modest." Resp. Br. 33. That is not how the Bank Board put it. According to that agency, its objective was to structure a transaction that "would * * * not change the economic position of the association after it engaged in the swap" (J.A. 58), "assur[e] that risk does not transfer" (J.A. 59), and "maintain the association's position with respect to the three types of risks in a loan portfolio" (J.A. 58).

Cottage, seeks to rely on differences in borrowers and collateral, the fact that the exchange was for 90% participation interests, and the fact that the loans eventually revealed different performances. Resp. Br. 17-18. As we have previously pointed out (Br. 26; *Cottage* Br. 33), an across-the-board rule based on the first two factors (such as that fashioned by the court of appeals) is far too sweeping and fails to take into account differences in contexts and transactions. The exchange of 90% participation interests, moreover, did not create a material difference in the properties *exchanged*, since 90% participation interests were swapped for substantially identical 90% participation interests. See Gov't *Cottage* Br. 33.[12] The reliance on eventual different performances is unavailing because the question of material difference turns on the significance of differences known at the time of the exchange, not on a *post hoc* evaluation of subsequent performance. The Internal Revenue Code could not properly be administered if we had to wait and see how property interests actually performed years down the road before determining whether or not they were materially different under the Regulation.

Respondent's claim that its swap of mortgage pools produced a deductible loss is thus premised both on a

[12] Indeed, the fact that 90% participation interests were exchanged, rather than 100% interests, actually reinforces the conclusion that there was no change in the taxpayer's economic position. The R-49 exchanges typically involved 90% interests so that the transferor would continue to service the entire loan and retain its relationship with the original borrower. Not even those incidents of mortgage ownership changed with the swap. As the district court noted, "the actual mortgages never changed hands, and borrowers were not aware that the transaction had taken place." Pet. App. 37a. Since no change of substance was contemplated by the swaps, it is not surprising that in the one case before this Court that *did* involve an exchange of 100% interests, the parties entered into a "Whole Loan Sale and Servicing Agreement," under which "the servicing of the loans would stay with the assignor institution." *United States* v. *First Federal Savings & Loan Ass'n*, 694 F. Supp. 230, 235 (W.D. Tex. 1988), aff'd, 887 F.2d 593 (5th Cir. 1989), petition for cert. pending, No. 89-1927.

crabbed construction of the "materially different" requirement and on an application of the requirement that ignores the perspective of the parties, the market, and the expert agency, and substitutes reliance on factors that were either unknown or insignificant at the time of the transactions. The Commissioner's reasonable construction of the Code and of his Regulation should be upheld, and the undisputed facts in the record establish that the claimed differences in the mortgage pools were not material.

6. The second issue presented is whether income received by respondent from its depositors as penalties for early withdrawal of their funds is excludable from gross income because it is income "by reason of the discharge * * * of indebtedness," within the meaning of Section 108 of the Internal Revenue Code. As we explain in our opening brief, not every debt that is cancelled or discharged results in income "*by reason of* the discharge" of the debt. I.R.C. § 108(a)(1) (emphasis added). If the cancellation of a debt is simply the method by which a creditor makes a payment to a debtor, the debtor does not have income "by reason of" a debt discharge; he has income "by reason of" receiving a payment, and that income does not qualify for the Section 108 exclusion. Respondent agrees with this general principle. Br. 38-40.[13]

Our brief further explains (at 33-35) that application of this principle requires the conclusion that respondent's receipt of early withdrawal penalties (through an offset of the amount returned to depositors) represents payment of a separate obligation, rather than income "by reason of" the discharge of indebtedness. Respondent disagrees (at 35-38, 40-46) with this conclusion, but its objections are not well founded.

a. As an initial matter, respondent ignores the fact that its offset of the amount due depositors simply re-

[13] Respondent's statement that the "spread" between the debt and the payment is the rule for discharge-of-indebtedness (Br. 36-37) thus must be read in light of the method-of-payment principle, with which respondent agrees (Br. 38-40).

flects its choice of the *method* for receiving early withdrawal penalties. We explain in our opening brief (at 33) that, if the depositors making premature withdrawals had paid the penalty due respondent in cash, and, in turn, received from respondent the entire amount due on their accounts, then respondent would clearly have had income from the payment of a penalty, not from the discharge of indebtedness. Respondent does not address, much less dispute, this point. The result should not be different simply because respondent chose a different method of receiving the penalty—namely, by an offset against the amount turned over to the depositor.[14]

b. That the early withdrawal penalty represents a separate obligation, rather than the discharge of indebtedness, is clear from the nature and purpose of the penalty: it is imposed not by the parties to the debtor/creditor relationship themselves but by federal regulations, and its purpose, even aside from the federal regulations, is to serve as a form of liquidated damages to compensate a financial institution for additional expenses. See Gov't Br. 34-35; *Colonial Savings Ass'n* v. *Commissioner*, 854 F.2d 1001, 1007 (7th Cir. 1988), cert. denied, 489 U.S. 1090 (1989). Respondent suggests that the early withdrawal payment should not be viewed as a "penalty"; it emphasizes that the 1981 version of the applicable regulation uses the term "forfeit," and suggests that the use of the term "penalty" in earlier versions of the regulation (which are also applicable in this case, see Gov't Br. 32 n.28) was a "misnomer." Resp. Br. 44-45 n.34. Respondent's effort is unavailing. First, to the extent that it matters, the word "penalty" remains in the very title of the 1981 regulation. See 12 C.F.R. 1204.103 (1981) ("Penalty for early withdrawals"). Second, Section 62(a)(9) of the Internal Revenue Code (26 U.S.C. (1988)), which governs the treatment of the depositor, similarly refers to "amounts forfeited * * * as a *penalty* for premature withdrawal of funds" (emphasis added). Third, respondent's own certificates of deposit set forth the amount of the penalty in a "Penalty Clause Section." J.A. 27-29. Respondent's effort now to recharacterize the obligation—by stating that "the penalty characterization was a misnomer and that, in substance, the regulation was effecting a reduction of indebtedness" (at 45 n.34)—is unsupportable.[15]

[14] Although failing to address the tax treatment of a cash payment of the penalty, respondent states that any discharge of indebtedness can be "recharacterized" as a two-step transaction. Br. 45. Unlike genuine income-by-reason-of-discharge-of-indebtedness transactions, however, each step of the transactions in this case has its own independent basis, purpose, and significance. The fact that the steps are related does not undermine the independent significance of each step, and the separateness of the obligations. See Gov't Br. 35 n.31.

c. Respondent repeatedly maintains that its receipt of early withdrawal penalties (through an offset) was income "by reason of" the discharge of indebtedness because the income would not have arisen "but for" the discharge of indebtedness for less than its full amount. See, *e.g.*, Resp. Br. 11, 39, 46. Recognition that the penalty is a separate obligation, however, highlights the fallacy of this contention. The depositor was obligated—by federal regulations and by what the Seventh Circuit aptly termed a "liquidated damages" provision (*Colonial Savings*, 854 F.2d at 1007)—to pay a penalty, and respondent's income arose "by reason of" that penalty. The income would not have arisen "but for" the discharge of indebtedness only because respondent chose an offset against the indebtedness as the method of payment for that obligation. Respondent's argument is essentially a

[15] Respondent claims (Br. 45 n.35) that we construe "forgiveness" of debt to mean discharge of debt without any consideration. Once again, respondent attacks a straw man; we do not contend that forgiveness necessarily means an absence of consideration. Our point, rather, is that respondent's offset did not result from forgiveness of a debt at all; it resulted from the separate obligation of the premature withdrawal penalty and the choice of the offset as the method of paying the penalty.

tautology: because it chose an offset method for receiving its income, its income would not have occurred "but for" the offset.[16]

In the classic case covered by Section 108, A lends B $1,000 payable in two months. After six weeks, A and B agree to call it quits if B pays $800. B has received $200 in income by reason of the discharge of his indebtedness to A. In the classic case *not* covered by Section 108, A lends B $1,000 payable in two months, provided that B need only pay back $100 if he paints A's house. If B paints A's house and pays back the $100, he has received $900 not by reason of the discharge of his debt to A, but because he painted A's house.

Respondent's proposed test for applying Section 108, however, would find income by reason of discharge of indebtedness in the second example. The $900 in income would not have arisen "but for" the discharge of indebtedness—A did not contract to pay B for painting his house, apart from the income B would realize from the agreed-upon discharge of indebtedness. As noted, the "but for" test thus proves too much, since it is satisfied whenever an offset against the amount owed is specified as the method of payment. In terms of the statutory language, "but for" is not the same as "by reason of." The statutory phrase "by reason of" looks to the source of the income—the "reason" for it. In the first example above, the source is the forgiveness of the debt; in the second, the source is the painting of the house. Here the source is

[16] Respondent points out (Br. 44 & n.34) that some of its certificates provided a penalty greater than the minimum amount required by the regulations. J.A. 27-29. Other certificates provided a penalty in the amount set forth in the regulations. PX 26. That some depositors may have paid penalties to respondent in amounts greater than the required minimum amount does not mean that the penalty obligation was not imposed by the regulations. The regulations required the depositor to pay a penalty, and merely allowed the institution to increase the amount of the penalty.

the federal regulation which requires payment of a penalty, not any forgiveness by the depositor of what the institution owes him.[17]

d. Since the penalty is a separate obligation owed by the depositor, respondent's reliance (Br. 41-42) on *Reliable Incubator & Brooder Co.* v. *Commissioner*, 6 T.C. 919 (1946), is misplaced. In *Reliable Incubator*, unlike the instant case, the creditor had no separate obligation to the debtor. Respondent's reliance (Br. 43) on *Columbia Gas System, Inc.* v. *United States*, 473 F.2d 1244 (2d Cir. 1973), is misplaced for a similar reason. In that case, the taxpayer converted its bonds into stock and did not pay the bondholders the accrued interest on the debt. The bondholders had no separate obligation to the taxpayer.[18]

e. We explain in our opening brief (at 35-37) that the conclusion that early withdrawal penalties represent a

[17] To cite another example, suppose federal law required payment of a $10 fee to a bank whenever a depositor withdraws funds. If respondent provided for payment of the fee by an offset against amounts withdrawn, its theory would lead to the conclusion that the fee was income "by reason of the discharge of indebtedness," even though there had been no premature withdrawal, because the income would not have arisen "but for" the withdrawal. Here the fact that the federal law obligation applies in a situation that might otherwise be characterized by negotiation between the parties leading to forgiveness of debt—as the price of premature discharge—should not obscure the fact that the payment arises "by reason of" a penalty imposed by federal law, and not any forgiveness or discharge.

[18] Respondent also contends that our "entire argument" rests on the fact that the penalty and method of payment were established in advance of the transactions; respondent then cites *Columbia Gas System* as the coup de grace knocking out this "entire argument." Resp. Br. 43-44. In fact, however, our position does not depend on the fact that the penalties were arranged in advance; rather, it rests on the fact that the penalty represents an independent obligation and the offset is a method of paying it. As our brief points out (at 35 n.31), the fact that the separate obligation was recognized by the parties from the outset serves to *corroborate* the conclusion that its payment did not constitute forgiveness or revision of the debt.

separate obligation from the debt owed to depositors is further buttressed by the Commissioner's analysis of the tax consequences for the depositor in a Revenue Ruling (Rev. Rul. 73-511, 1973-2 C.B. 402), and by Congress's reaction to that analysis. Respondent concedes, as it must, that "[t]he ruling treats the forfeiture as a transaction separate from the payment or crediting of interest." Br. 47. Inasmuch as Congress explicitly relied on the analysis in this ruling in crafting a deduction for depositors' penalties (see Gov't Br. 36-37), this concession powerfully supports the Commissioner's position that the penalty is a separate obligation from the debt and that the use of an offset is a method of payment, rather than a discharge of indebtedness.

But respondent finds an entirely different distinction lurking in the Revenue Ruling. In respondent's rendition, the ruling "held that a premature withdrawal forfeiture was not a discharge of the interest, but was a discharge of the principal." Br. 47. Nothing in the Revenue Ruling supports this attempted distinction between interest and principal; indeed, the ruling explicitly states that the penalty was paid by "the forfeiture of *a portion of the interest* previously paid." 1973-2 C.B. at 403 (emphasis added). The ruling is equally clear that the distinction it is drawing is not between principal and interest, but between the payment of interest and the early withdrawal penalty: "the interest paid or credited and the forfeiture incurred represent two separate transactions and are taxable as such." *Ibid.*[19]

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[19] The legislative history of the resulting congressional provision (Section 62(a)(9)) also reveals the congressional understanding that early withdrawal penalties ordinarily are paid out of previously credited interest rather than out of principal. See H.R. Conf. Rep. No. 1405, 93d Cong., 2d Sess. 5 (1974) (upon early withdrawal, depositor "is required to forfeit part of the interest previously earned"; new law permits nonitemizers "to obtain the benefit of a deduction for interest forfeited"); 120 Cong. Rec. 28,117 (1974) (Sen. Church) (effect of early withdrawal penalty is that

Respondent further contends that the Revenue Ruling's conclusion that the depositor can deduct the amount of the penalty as a "loss" under Section 165 of the Code (1973-2 C.B. at 403) establishes that the premature withdrawal payment is not a separate obligation or penalty. Br. 48. Respondent's suggestion that the payment of "obligations" can never be a "loss" for purposes of Section 165, however, is clearly wrong. See, *e.g.*, *Stephens* v. *Commissioner*, 905 F.2d 667 (2d Cir. 1990) (restitution payment deductible as loss under Section 165); Rev. Rul. 67-48, 1967-1 C.B. 50 (amount paid by taxpayer to former employer as liquidated damages for breach of employment contract deductible as loss under Section 165).[20]

f. Finally, respondent also suggests that the sole purpose of Section 108 is to alleviate the hardship of taxing income from the discharge of indebtedness because the discharge does not generate cash with which to pay the tax, and emphasizes that it received no cash from the transaction. Br. 36-37. As we point out in our opening brief (at 38-39), the statutory purpose of Section 108 and its predecessor was also to provide an incentive for liquidation of indebtedness—a purpose wholly inapplicable to the completely creditor-controlled early withdrawals here. In emphasizing the lack of cash to pay taxes on the income resulting from the early withdrawals, respondent also fails to point out that, pursuant to Section 591 of the Code, a savings institution also receives full deductions for the interest paid to depositors, *including* any interest sacrificed by depositors as penalties for early withdrawals. See *Colonial Savings Ass'n* v. *Commissioner*, 85 T.C. 855,

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interest is paid or credited and depositor is "required to return part of it to the financial institution as a penalty").

[20] See also Rev. Rul. 83-60, 1983-1 C.B. 39, 41 (noting that the prior determination that a depositor is allowed a deduction under Section 165 "does not require a conclusion that a forfeiture suffered upon a premature withdrawal of a certificate may not be characterized as 'payment' of a penalty to the [savings institution]").

864 n.15 (1985), aff'd, 854 F.2d 1001 (7th Cir. 1988), cert. denied, 489 U.S. 1090 (1989); Treas. Reg. § 1.591-1(b).[21]

* * * * *

For these reasons and those set forth in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

JOHN G. ROBERTS, JR.
Acting Solicitor General *

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[21] Respondent states (Br. 7) that the forfeitures were from principal. Although it makes no difference to the proper legal analysis, the extent to which the penalties were paid from interest or principal, or both, in this case has not been established. Cf. Rev. Rul. 83-60, 1983-1 C.B. at 39-40 (explaining that penalties may be from interest or from principal). Respondent also mischaracterizes our position as requiring a "solvency" inquiry. Resp. Br. 36 n.30. This contention is incorrect. See Gov't Br. 38 n.36.

* The Solicitor General is disqualified in this case.

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AMICUS CURIAE

BRIEF

Supreme Court, U.S.
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(8)

No. 89-1926

In The
Supreme Court of the United States

OCTOBER TERM, 1990

UNITED STATES OF AMERICA,
Petitioner,

v.

CENTENNIAL SAVINGS BANK, FSB
(RESOLUTION TRUST CORPORATION, RECEIVER),
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF *AMICUS CURIAE* OF MAIN LINE FEDERAL SAVINGS BANK, PRIME SAVINGS BANK, FSB, AND CENTRAL PENNSYLVANIA SAVINGS ASSOCIATION, PSA IN SUPPORT OF RESPONDENT

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IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1990

NO. 89-1926

UNITED STATES OF AMERICA,

Petitioner,

v.

CENTENNIAL SAVINGS BANK, FSB
(RESOLUTION TRUST CORPORATION, RECEIVER),

Respondent.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

BRIEF *AMICUS CURIAE* OF MAIN LINE FEDERAL SAVINGS BANK, PRIME SAVINGS BANK, FSB, AND CENTRAL PENNSYLVANIA SAVINGS ASSOCIATION

This brief is jointly submitted by Main Line Federal Savings Bank ("Main Line"), Prime Savings Bank, FSB ("Prime"), and Central Pennsylvania Savings Association, PSA ("CPSA") (sometimes hereafter referred to collectively as the "Institutions") in support of respondent. Pursuant to Supreme Court Rule 37, written consents to the submission of this brief have been given by counsel for respondent and the Acting Solicitor General and have been filed with the Clerk of the Court. Hereafter, respondent shall sometimes be referred to as "Centennial" and petitioner shall sometimes be referred to as the "government".

SCOPE OF THIS BRIEF AND INTEREST OF THE AMICI CURIAE

This brief addresses both of the issues presented in the case before the Court: (i) the deductibility of losses from the reciprocal purchase and sale of participation interests

in mortgage loans (such participation interests hereafter being referred to as "mortgages" or "mortgage loans") pursuant to Federal Home Loan Bank Board ("FHLBB") Memorandum R-49 ("R-49"); and (ii) the characterization of the relief of Centennial's obligation to repay depositors monies owing on their time deposits when such amounts are prematurely withdrawn as income from discharge of indebtedness. The mortgage issue ((i)) is also before this Court in *Cottage Savings Ass'n v. Commissioner*, 890 F.2d 848 (6th Cir. 1989) ("*Cottage*"), *rev'g* 90 T.C. 372 (1988), *cert. granted*, 111 S. Ct. 40 (1990).

The Institutions are each savings and loan associations located in Pennsylvania. Each of the Institutions currently has pending before the United States Tax Court cases involving the deductibility of losses in connection with the reciprocal purchase and sale of mortgages pursuant to R-49 and the treatment of income from the premature withdrawal of time deposits as income from discharge of indebtedness. The transactions giving rise to the controversies involving the Institutions occurred in the years 1980 and 1981 and the legal issues relating thereto are substantially the same as those presented in the case before the Court.[1] Each of the Institutions, during the years subject to the pending Tax Court controversy, was regulated by the FHLBB. None of the Institutions is insolvent or in receivership nor has any of the Institutions been taken over or threatened with being taken over by any federal agency (including the Resolution Trust Corporation, the Office of Thrift Supervision or the Federal Deposit Insurance Corporation). It may fairly be said that each of the Institutions is in stable financial condition. It is partly for this reason that the Institutions feel it is important that it be brought to the attention of this Court that the Court's disposition of this case could have a substantial

[1] The litigation involving the Institutions is docketed as follows: *Main Line Federal Savings Bank and Subsidiaries v. Commissioner* (Tax Ct. Docket No. 19834-88); *Cheltenham Federal Savings and Loan Association, n.k.a. Prime Savings Bank, FSB v. Commissioner* (Tax Ct. Docket No. 3912-90); *Central Pennsylvania Savings Association and Subsidiaries v. Commissioner* (Tax Ct. Docket No. 19498-89).

impact on numerous solvent and well managed savings and loan associations. The Institutions and other similarly situated saving and loan associations have a significant interest in the Court's disposition of the this case and of the *Cottage* case.

An adverse decision in the present case could have a far-reaching negative impact on the financial viability of many saving and loan associations. In particular, many of the currently financially solvent savings and loan associations which have been well operated and managed have, nonetheless, experienced adverse financial consequences as a result of the fallout from the federal effort to bail-out other savings and loan associations. An adverse decision on the legal issues presented in this case and in *Cottage* could further impair the financial conditions of such institutions.

SUMMARY OF ARGUMENT

Exchanges Of Mortgages

This Court should sustain Centennial's loss deductions (and the loss deductions claimed by the taxpayer in *Cottage)*. The proper test for determining whether properties "differ materially" within the meaning of Treas. Reg. Section 1.1001-1(a) is whether they are inherently different from each other. Extrinsic and subjective factors such as the intent of the parties, marketplace perceptions, and regulatory accounting practices are not determinative of the issue in question.

The mortgages exchanged pursuant to R-49 differed materially because they had different obligors and different underlying collateral. Accordingly, the full amount of the losses claimed by Centennial (and Cottage) were fully realized and recognized and therefore are allowable.

Income From Premature Withdrawals Of Time Deposits

The income realized by Centennial from the premature withdrawal of time deposits constitutes income from the

discharge of indebtedness, within the meaning of Section 108 of the Code.[2] The relationship between Centennial and its depositors was that of debtor and creditor. Pursuant to the time deposit agreements which Centennial had with its depositors, such depositors had agreed to lend Centennial money for a specified period of time at a specified interest rate and further agreed that if the money was withdrawn prior to the expiration of such time period, the obligation of Centennial in connection therewith would be reduced. This reduction in Centennial's obligation arose out of the single debtor/creditor relationship and does not constitute a separate obligation. Characterization of such reduction as a "penalty" for regulatory purposes does not control the characterization for federal income tax purposes. Accordingly, the reduction in Centennial's obligation constitutes income from discharge of indebtedness.

ARGUMENT

I. THE LOSS DEDUCTIONS CLAIMED BY CENTENNIAL WERE ALLOWABLE BECAUSE THE MORTGAGES EXCHANGED WERE MATERIALLY DIFFERENT UNDER TREAS. REG. SECTION 1.1001–1(a).

A. The Determination Of Whether The Mortgages Differ Materially Is Made Only By Reference To The Mortgages And Is Not Governed By Economic Similarities, The Intention Of The Parties Or The Characterization By Others.

The scope of the argument contained in this brief is generally limited to an analysis of why the mortgages at issue herein differ materially. This assumes *arguendo* that one

[2] Unless otherwise indicated, statutory references are to the Internal Revenue Code of 1954, as amended, (26 U.S.C. (1982)), as in effect for the years at issue (the "Code").

requirement for realization of losses from the exchange of properties under Section 1001 of the Code is that such properties differ materially.[3]

The Institutions acknowledge that there are numerous other bases, not addressed in this brief, upon which the losses at issue herein are properly allowed. Such other bases are, however, fully developed in the other briefs filed in this case in support of respondent, and the positions contained therein are endorsed by the Institutions.[4]

The determination of when a loss has been sustained is made by reference to Section 1001 of the Code - the provision giving rise to the controversy in the present case. Section 1001(a) of the Code provides:

> The gain from the sale or other disposition of property shall be the excess of the *amount realized* therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized. (emphasis added)

[3] A loss may only be recognized if it is first realized. Section 1001(c) of the Code provides, in pertinent part, "[e]xcept as otherwise provided...the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized."

[4] One such basis is that all that is required for gain or loss to be realized on an exchange of properties is that there be a complete termination of the property rights transferred. The characteristics of the property or rights received is irrelevant. *See Cottage Savings Association v. Commissioner*, 890 F.2d 848 (6th Cir. 1989), rev'g 90 T.C. 372 (1988), *cert. granted*, 111 S. Ct. 40 (1990), *First Federal Savings & Loan Ass'n v. United States*, 694 F.Supp. 230 (W.D. Tex. 1988), aff'd 887 F.2d 593 (5th Cir. 1989), *petition for cert. pending*, No. 89-1927 (June 8, 1990); concurring opinion in *Cottage Savings Association v. Commissioner*, 90 T.C. at 403. This argument is more fully developed in the brief *amicus curiae* submitted by the United States League of Savings Institutions in support of respondent herein. The Institutions' ultimate position herein is not inconsistent with this analysis. The Institutions submit that realization of gain or loss for federal income tax purposes is not dependent upon whether exchanged properties differ materially and, to the extent Treas. Reg. Section 1.1001-1(a) (discussed *infra*) is construed to contain such a requirement, such regulation is invalid.

In its brief, the government states that "[t]he pertinent Treasury Regulation provides that an exchange of property is a realization event if it involves 'property *differing materially* in kind or extent.'" The text of the regulation states the standard differently.[5] Treas. Reg. Section 1.1001-1(a) states, in pertinent part:

> Except as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property into cash, or from the exchange of property for other property differing materially either in kind or extent, is treated as income or as loss sustained.

Both the District Court in *Centennial*[6] and the government in its brief[7], have placed great emphasis on the fact that the exchanged mortgages were matched pursuant to the R-49 criteria which characterized them as "substantially identical" for regulatory accounting purposes, perhaps inferring that regulatory characterization should control the determination of whether the mortgages differ materially for federal income tax purposes. In fact, the District Court in *Centennial* appears to have based its determination — that the mortgages did not differ materially — at least in part on the fact that the mortgages were classified as substantially identical under R-49.[8] This conclusion is clearly improper. It is well established that the accounting requirements of regulatory agencies (such as the FHLBB) are not controlling in the application of the revenue laws. *See Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979).[9] As such, characterization of the mortgages as being "substantially identical" for regulatory accounting purposes does not control nor, it is asserted, does such characterization have any impact whatsoever on whether the mortgages differ materially for federal income tax purposes.

The government also contends that in the context of the R-49 transactions at issue herein, evidence of whether the exchanged mortgages differ materially includes such factors as the conduct and intent of the parties and the secondary mortgage market. For example, the government asserts that the failure of Centennial to engage in certain underwriting functions with respect to the mortgages and the application of a common discount factor in valuing the mortgages reflects an indifference on the part of the parties regarding the property (the mortgages) exchanged. The government concludes that such conduct and intent are probative of the nature of the transaction, including whether the mortgages differ materially.[10] Similarly, according to the government, an analysis of the secondary mortgage market would allegedly lead to the conclusion that the exchanged mortgages are economically indistinguishable and do not differ materially.[11]

---

[5] Gov't Brief at 14, citing Treas. Reg. Section 1.1001-1(a). The Tax Court in *Cottage*, *supra* note 4 at 390-391, questioned the construction by the Commissioner of Internal Revenue ("Commissioner") of Treas. Reg. Section 1.1001-1(a) because the Commissioner's construction limited realization to transactions in which property is exchanged for other property differing materially in kind or extent. The Tax Court observed that the Commissioner's construction appears to be equivalent to the converse of the language that is actually in the regulation. The regulation could have, but does not state that the only way in which there is realization is where exchanged properties differ materially and the Tax Court notes that a prior regulation (Treas. Reg. 45, Art. 1563 (1920 ed.)), interpreting sec. 202 of the Revenue Act of 1918 (see sec. 1405 of the Act, 40 Stat. 1151), Pub. L. 65-254, 40 Stat. 1057, 1060, Art. 1563, required that there be "a change in subetance" in order for gain or loss to be realized. The Tax Court suggested that since the current regulation omits any statement that there cannot be a realization unless there is a change in subetance, it may be inferred that in changing the language of the regulation the Commissioner intended to change the meaning.

[6] *Centennial Savings Bank FSB v. United States*, 682 F.Supp. 1389 (N.D. Tex. 1988) at 1399.

[7] Gov't Brief at 17-28.

[8] *Centennial*, *supra* note 6 at 1399-1400. The Court concludes (on page 1400) that "[i]f Centennial claims the benefits of alleged business purposes for entering into the R-49 transactions, it must also bear the burdens. It cannot have its cake and eat it too."

[9] *See also* the Tax Court opinion in *Cottage*, *supra* note 4 at 400, citing *Bellefontaine Federal Savings & Loan Association v. Commissioner*, 33 T.C. 808 (1960).

[10] Gov't Brief at 19-20.

[11] Gov't Brief at 21-23. The government relies in part on *Emery v. Commissioner*, 166 F.2d 27 (2d Cir. 1948) and *Hanlin v. Commissioner*,

The factors which the government urges should be considered in determining whether the mortgages differed materially — conduct and intent of the parties, operation of the secondary mortgage market and regulatory accounting practices and policies — are not in fact determinative and, rather than providing a clear guideline for applying the material difference test tend to obscure the issue. The law does not support reference to extrinsic and subjective factors, as opposed to the inherent characteristics and property rights of the exchanged mortgages. If the Court were to adopt the government's asserted position, the test would be nearly impossible to administer. The government's approach would require subjective determinations of intent and marketplace perceptions, among other factors, in virtually all transactions involving exchanges of property. Treas. Reg. Section 1.1001-1(a) requires only that the properties exchanged differ materially, regardless of the motives or intent of the parties to the exchange, market conditions, or the accounting treatment of the transaction for regulatory purpose.[12]

The regulatory requirement that exchanged properties must differ materially in order for gain or loss to be realized can be construed in one of two ways. In its narrowest construction, the regulation contemplates that the exchanging party will not have a continuing interest in the *same* property. Thus, a taxpayer who exchanges a share of stock for a voting trust certificate evidencing an ownership interest in the same stock would not have experienced a realization event. In its broadest construction, the regulation contemplates that the property received in the exchange does not confer the same property rights as the property surrendered. Under this construction, for example, an exchange of a bushel of wheat for another bushel of wheat from the same field, harvested at the same time,

108 F.2d 429 (3d Cir. 1939). In both of these cases, however, the characteristics of the exchanged securities at issue therein were ultimately the determining factors rather than how the parties or the marketplace viewed them.

[12] *See Marr v. United States*, 268 U.S. 536 (1925); *Weiss v. Stearn*, 265 U.S. 242 (1924) at 254.

would typically confer the same property rights on the parties and the exchange would not constitute a realization event. This follows, not because the marketplace "perceives" the differences between the two bushels to be insignificant, but because, in fact, there is no difference between the two.[13]

Regardless of which of the foregoing constructions is correct, the exchanges at issue herein were unquestionably realization events. The individual mortgages were separate and distinct properties conferring separate and distinct property rights (i.e., each mortgage had a different obligor and was secured by different underlying collateral). The government's argument that the properties do not differ materially could *only* be sustained on the basis of a statistical argument that the mortgage "pools" exchanged are statistically the same. The problem with this argument is that the mortgages are, in fact, separate, distinct and very different properties and could only be considered "fungible" in a statistical sense. Statistics disregard the inherent characteristics of each individual mortgage and reliance on statistical analysis is not supported by the regulation. Statistically, human beings could be viewed as fungible (i.e. to a life insurance company or a group health insurer) but there should be no question that individuals differ materially from one another.

The Tax Court in *Cottage* as well as the Fifth and District of Columbia Circuit Courts of Appeals[14] examined the inherent characteristics of the mortgages to determine

[13] *See* Gov't Brief at footnote 18.

[14] *Cottage*, *supra* note 4. In *Cottage*, all 16 Tax Court Judges joined in the decision which was based, in large part, on the analysis set forth in *Hanlin v. Commissioner*, 108 F.2d 429 (3rd Cir. 1939). *See also San Antonio Savings Association v. Commissioner*, 887 F.2d 577 (5th Cir. 1989), *aff'g* 55 T.C.M. (CCH) (1988), *Petition for cert. pending*, No. 89-1928 (June 8, 1990); *Centennial Savings Bank FSB v. United States*, 887 F.2d 595 (5th Cir. 1989), *rev'g* 682 F. Supp. 1389 (N.D. Tex 1988), *petition for cert.* granted No. 89-1926 (Oct. 1, 1990); *Federal National Mortgage Ass'n v. Commissioner*, 896 F.2d 580 (D.C. Cir. 1990), *aff'g* 90 T.C. 405 (1998), *petition for cert. pending*, No. 89-1987 (June 19, 1990) ("*FNMA*").

whether they differed materially. These courts concluded that because each individual mortgage had a different obligor and was secured by separate collateral, the mortgages differed materially under Treas. Reg. Section 1.1001-1(a). The inherent value of each mortgage depends on the credit worthiness of the mortgagor and the value of the underlying collateral.

The Fifth Circuit in *San Antonio* noted that compliance with the "materially different" standard of Treas. Reg. Section 1.1001-1(a) is not determined on the basis of economic differences in the properties exchanged. The Court pointed out that "[t]he case law which establishes the requirement of material difference as a part of realization simply does not equate 'materially different' with 'not an economic substitute.' "[15] The Fifth Circuit refused to read a universal like-kind exchange rule into the requirement of material difference. Instead, the Fifth Circuit concluded that the proper standard is that the asset given up must be really and truly different from the asset received in order for an exchange to be a realization event. The Fifth Circuit concluded that the fact the properties may be viewed as economic substitutes does not control whether they will be considered materially different, and held that while material difference requires more than purely formal differences, economic substitutes can still be materially different. The fact that the marketplace may view two properties as economic substitutes is not determinative of whether one property in inherently different from another.[16]

On the basis of the foregoing, the proper inquiry in determining whether one property received in an exchange differs materially from another should be made by reference to the inherent characteristic of the exchanged properties and not to extrinsic or subjective factors.

[15] *San Antonio*, *supra* note 14 at 589-590.
[16] Id. at 590, citing *Weiss v. Stearn*, 265 U.S. 242 (1924).

B. The Mortgages Exchanged By Centennial Differed Materially.

The Tax Court in *Cottage* distinguished the exchanges effected pursuant to R-49 from exchanges in certain of the cases relied upon by the Commissioner in support of its argument that the mortgages did not differ materially.[17] In *Horne v. Commissioner*, 5 T.C. 250 (1945), the taxpayer sold a certificate representing his membership on a securities exchange in order to establish a loss for federal income tax purposes. Prior to the sale, however, the taxpayer bought another certificate which differed from the one sold only by the identifying number on the certificate itself. The Tax Court in *Horne* disallowed the tax deduction because following the sale of the certificate, the taxpayer stood in exactly the same position as before the sale.

In *Shoenberg v. Commissioner*, 77 F.2d 446 (8th Cir. 1935), *aff'g* 30 B.T.A. 659 (1934), the taxpayer sold shares of stock for purposes of establishing a tax loss but directed a broker to purchase a like number of the same shares for a wholly-owned corporation. Thereafter, the shares were transferred back to the taxpayer from the corporation. The court disallowed the deduction because, viewing the situation as a whole, the taxpayer was at all times in control of shares of stock which were indistinguishable.

The Tax Court and the Fifth and District of Columbia Circuit Courts of Appeals concluded that, unlike the property exchanged in *Horne* and Shoenberg, the mortgages exchanged pursuant to R-49 were not identical. Although there may be economic similarities in the groups of mortgages exchanged, there were differences which each of the courts considered material. The most significant of these differences is the fact that each of the mortgage loans had a different obligor and was secured by different underlying collateral.[18] That the mortgages were different was confirmed by the fact that they ultimately performed differ-

[17] *Cottage*, *supra* note 4 at 392 through 396.
[18] See *Cottage*, *supra* note 4 at 394; *San Antonio*, *supra* note 14 at 592; *Centennial*, *supra* note 14 at 609; *FNMA*, *Supra* note 14 at 584.

ently.[19] As the Tax Court in *Cottage* noted, a misfortune affecting one family or one property could affect what happens to that obligation without affecting any of the other obligations.[20]

Accordingly, the existence of different obligors and different underlying collateral establishes that the mortgages are materially different. The fact that the parties, the marketplace or the regulators view the mortgages as economically similar (on a "pooled" basis) is immaterial to this determination.

C. The Losses Resulting From The Exchange Of Mortgages Pursuant To R-49 Is Not Barred By Section 165 Of The Code.

Section 165 of the Code provides the operative rule for when a deduction for losses is allowable. A loss which is realized and recognized under Section 1001 of the Code is deductible under Section 165 of the Code.

Treas. Reg. Section 1.165-1(b) provides, in pertinent part, "[t]o be allowable as a deduction under Section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and ... actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss."[21]

---

[19] *See San Antonio*, *supra*, note 14 at 591. The Court observed that post hoc analysis of the economic performances of the exchanged mortgages did not prove that the mortgages differed materially, but merely confirmed that they did.

[20] *Cottage*, *supra* note 4 at 395. The Tax Court also observed that before the transaction, the bank owned whole mortgages and after the transaction, it owned participation interests in mortgages which are generally less marketable (and therefore economically different) than whole loans.

[21] The Sixth Circuit in *Cottage* concluded that the losses were not allowable under Section 165 of the Code. This conclusion was based on the assertion that because there was no change in Cottage's economic position, no loss was sustained. Although the government acknowledges

It is undisputed that the mortgages exchanged by Centennial in the R-49 transactions in issue had declined in value, resulting in a change in Centennial's economic position.[22] Further, it was not disputed that the R-49 transactions were, in fact, closed and completed.[23] Accordingly, all of the requirements of Section 165 of the Code were met and the losses therefore are allowable.

II. INCOME FROM PREMATURE WITHDRAWAL OF TIME DEPOSITS CONSTITUTES INCOME FROM DISCHARGE OF INDEBTEDNESS.

The relationship between a bank and its depositors is properly characterized as that of creditor and debtor for federal income tax purposes.[24] The government, in its brief, refers to federal banking regulations which provide for a "penalty" on the depositor in the case of withdrawals of time deposits prior to maturity.[25] In its brief, the government states that under the terms of the certificates in issue, the depositor received a single net amount from Centennial, consisting of the principal on deposit plus interest payable to the date of withdrawal, less the penalty.[26]

The government's argument, and the argument of the Seventh Circuit Court of Appeals in *Colonial Savings Association v. Commissioner*, 854 F.2d 1001 (7th Cir. 1988), *aff'g* 85 T.C. 855 (1985), *cert. denied*, 109 S. CT. 1556 (1989), is that the "penalty" imposed for premature with-

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the Sixth Circuit's decision, it is not relied upon by the government. See Gov't Brief at 16-17.

[22] Gov't brief at 2.

[23] Gov't Brief at 4-6.

[24] *See Paulsen v. Commissioner*, 716 F.2d 563 (9th Cir. 1983), aff'd, 469 U.S. 131 (1985) (addressing the relationship of bank and depositor in connection with exchanges of passbook accounts and certificates of deposit in transactions structured as reorganizations).

[25] Gov't brief at 32. Pursuant to Section 1017 of the Code, Centennial elected to reduce the basis of its depreciable assets in lieu of currently recognizing the discharge of indebtedness income arising (under Section 108 of the Code) from the premature withdrawls. *See* Gov't Brief at 5.

[26] Gov't brief at 32.

drawals is an obligation separate from the time deposit. The government argues that the penalty is imposed from outside the debtor/creditor relationship by federal regulatory law and does not, therefore, constitute discharge of indebtedness.[27]

It should again be noted that the characterization of the arrangement for regulatory purposes does not control for purposes of applying the tax laws.[28] For federal income tax purposes, the characterization of the transaction is clear. The depositor had agreed to lend money to the bank for a specified period of time after which the bank was to repay the principal plus interest. If the depositor withdrew the funds prior to the agreed upon expiration of the loan, the amount the bank was obligated to repay was reduced. Regardless of whether the banking laws dictated the circumstances of such reduction, the fact of the matter is that the bank was discharged from a portion of its debt obligation. There should be no question that the reduction in the obligation constitutes a discharge of indebtedness under Section 108 of the Code.[29]

The government also attempts to characterize the early withdrawal transaction as one in which the depositor pays the bank the full amount of the penalty in cash and the bank pays the depositor the full amount of the debt. The government argues that there is full repayment of the debt and the cash paid by the depositor is a fully taxable penalty under Section 61(a) of the Code in the year of receipt.[30] This theory could be used to defeat nearly all debt discharges by permitting the government to characterize the reduction in debt repayment as springing from

[27] Gov't brief at 34.

[28] *See Thor Power Tool Co., supra* and *Cottage Savings, supra* at 402.

[29] The government observes that the regulatory purpose for imposing the premature withdrawal penalties is to deter early withdraws, minimize bank costs, enable banks to manage their liabilities, and ensure the systematic health of the nations banking institutions. Gov't Brief at 34. These reasons do not, however, bear on the federal tax treatment of the transaction.

[30] Gov't brief at 33.

some separate event or obligation of the creditor and asserting that the creditor repaid the full amount of debt and received a cash payment by reason of such other "obligation".

The Fifth Circuit's decision in *Centennial*, wherein it concluded that reduction in Centennial's obligation to its depositors was "bargained for as an integral part of the single transaction" and, therefore, becomes an indistinguishable element of the debtor/creditor relationship, reflects the proper view of the premature withdrawal situation.[31] Accordingly, the reduction in Centennial's obligation to its depositors is properly characterized as discharge of indebtedness under Section 108 of the Code.

[31] *Centennial, supra*. note 18 at 605.

CONCLUSION

The judgment of the United States Court of Appeals for the Fifth Circuit should be affirmed.

Respectfully submitted,

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December 17, 1990

AMICUS CURIAE

BRIEF

No. 89-1926

DEC 17 1990

IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

UNITED STATES OF AMERICA,
Petitioner,

v.

CENTENNIAL SAVINGS BANK, FSB
(RESOLUTION TRUST CORPORATION, RECEIVER),
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF *AMICUS CURIAE* OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION IN SUPPORT OF RESPONDENT

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On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

---

BRIEF *AMICUS CURIAE* OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION IN SUPPORT OF RESPONDENT

The Federal National Mortgage Association ("FNMA") submits this brief *amicus curiae* in support of respondent. Pursuant to Supreme Court Rule 37.3, written consents to the submission of this brief given by counsel for respondent and the Acting Solicitor General have been filed with the Clerk of the Court.

INTEREST OF THE *AMICUS CURIAE*

FNMA is a privately-owned corporation created pursuant to the Federal National Mortgage Association Charter Act. 12 U.S.C. § 1716 *et seq.* Established in 1938 as an agency of the federal government, FNMA became privately owned in 1968. FNMA remains subject to regulation by the Secretary of the Department of Housing and Urban Development ("HUD"). The President of the United States appoints five of FNMA's directors. FNMA has a Congressional mandate to provide liquidity

to the nation's residential mortgage market through its operations in the "secondary market" in which existing mortgages are bought and sold. FNMA carries out this mandate primarily by purchasing mortgages from lenders, thereby replenishing lenders' funds for additional lending.

One of the issues in this case concerns the tax deductibility of losses sustained in two "R-49" mortgage exchange transactions entered into by respondent, Centennial Savings Bank ("Centennial"). FNMA was the other party to these two exchanges, and it is the respondent in a related case with respect to which a petition for certiorari is pending before the Court.[1] FNMA engaged in a total of 71 R-49 transactions, and it is the taxpayer with by far the greatest amount of tax at issue relating to such transactions. FNMA thus has a significant interest in the Court's disposition of the present case (and *Cottage Savings Ass'n v. Commissioner*, 890 F.2d 848 (6th Cir. 1989), *cert. granted*, No. 89-1965 (Oct. 1, 1990), which raises the same issue).

FNMA respectfully submits that it can meaningfully contribute to the Court's evaluation of the mortgage exchange issue in a number of ways.

First, given its stature as the largest purchaser of home mortgages in the secondary mortgage market and the enormous amount of taxes it has at stake, FNMA had the ability and incentive to, and did, fully develop the factual record regarding the mortgage market—facts that are relevant to the disposition of all of the R-49 cases.

Second, because FNMA was the other party to the exchanges at issue in this case, it can ensure that the Court has before it all of the relevant facts regarding these transactions.

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[1] *Federal National Mortgage Ass'n v. Commissioner*, 896 F.2d 580 (D.C. Cir. 1990), *aff'g* 90 T.C. 405 (1988), *petition for cert. filed*, No. 89-1987 ("*FNMA*").

Third, petitioner itself recognized in its reply brief to the brief in opposition filed in one of the other R-49 cases, *United States v. First Federal Savings and Loan Ass'n of Temple, petition for cert. filed*, No. 89-1927, that FNMA's facts are unique in several respects. Pet. *First Federal* Reply Br. at 2 (the *FNMA* case "arises in an atypical factual context"). As explained below, under the controlling legal principles the taxpayer should prevail in every R-49 case. If this Court does not resolve the issue on that basis, however, the Court should take into account the individual facts of the *FNMA* case in crafting its opinion. In particular, the Court should recognize the extensive evidence that led to the Tax Court findings in *FNMA* (which were upheld on appeal) that (a) the mortgages transferred by FNMA were materially different from those it received in exchange, (b) FNMA engaged in the R-49 transactions, recognizing the risks inherent in exchanging materially different properties, in order to realize significant nontax objectives as well as tax objectives and (c) one major motivation for FNMA's participation in the transactions was to diversify its mortgage portfolio by exchanging nonurban mortgages for urban mortgages.

SUMMARY OF ARGUMENT

1. The Internal Revenue Code provides that gain or loss with respect to property is to be taken into account for federal income tax purposes when realized, and it presumes that realization occurs upon every disposition of property by sale, exchange or other taxable event. 26 U.S.C. § 1001(a). When the disposition is by exchange, however, the controlling Treasury regulation adopts a narrower standard, providing that realization occurs only if the exchanged assets are "materially different." 26 C.F.R. § 1.1001-1(a). This materially different standard has its genesis in decisions of this Court that date back 65 years. Under these decisions, it is well-settled that

exchanges result in realization unless the assets exchanged represent the same property rights. Thus, realization occurs even if the exchanged assets are of like kind or are likely to exhibit similar economic performance. Under the standard set by this Court, an exchange will fail to result in realization only in the narrow circumstance where there is such an identity between the exchanged properties that the taxpayer holds the same property rights before and after the exchange.

2. The mortgages exchanged in the R-49 transactions had different obligors and were secured by different underlying properties. These differences are material because they entitled the mortgages' owners to different economic rewards and subjected them to different economic risks. No two mortgages or groups of mortgages will necessarily have the same performance in terms of delinquencies, foreclosures and prepayments, because the particular characteristics of the obligor and underlying property of each mortgage influence the timing and extent of payments and the extent of security. Consequently, exchanged mortgages are materially different as a matter of law, and the courts thus need not inquire into the particular facts of each mortgage exchange.

Even if such a factual inquiry were necessary, however, the record in the *FNMA* case confirms that the mortgages exchanged were materially different. The participants matched the mortgages according to criteria set forth in Memorandum R-49, but these criteria did not require that the exchanged mortgages be matched according to a host of factors likely to bear upon the mortgages' performances. That the exchanged mortgages subsequently performed differently in terms of delinquencies, foreclosures and prepayments (as the *FNMA* record demonstrates) confirms that they were materially different.

3. Petitioner erroneously contends that differences between the exchanged mortgage pools were not material

because (1) the parties to the exchange were unconcerned about, and did not take into consideration, those differences when conducting the transaction, and (2) the "marketplace" did not view the differences as material. Petitioner's subjective approach is unprecedented and unsound. An inquiry into the subjective views of the parties or of the "marketplace" is unnecessary and inappropriate—the proper test is based on the objective characteristics of the exchanged mortgages, which prove that the mortgages were materially different. Moreover, basing the tax consequences of the R-49 exchanges (or any transaction) even partially on the subjective intentions of the parties would be a grave error. It would lead to disparate results for economically identical transactions, based solely on actual or alleged differences in the parties' perceptions, thereby leaving the R-49 issue unresolved and raising new issues regarding the now-settled tax treatment of exchanges of bonds and other securities. Finally, even if petitioner's subjective standard were correct, it is satisfied here. FNMA, a participant in 71 R-49 exchanges and the largest participant in the relevant "marketplace," did care about differences such as existed here when conducting its secondary market transactions. In particular, the location of the underlying properties provided a significant motivation for FNMA's entering into the R-49 transactions: to acquire urban mortgages in exchange for nonurban mortgages.

4. The Federal Home Loan Bank Board ("FHLBB") staff's determination that the R-49 criteria rendered the exchanged mortgages "substantially identical" for financial and regulatory accounting purposes does not control the tax treatment of the transactions. *See Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979). Moreover, if anything was wrong with the FHLBB staff's attempt to permit different accounting and tax treatment of the R-49 transactions, it was the determination that no loss need be recognized for accounting purposes. In-

deed, the relevant accounting rules have recently been clarified so as to require the reporting of losses in such transactions, because the mortgages have different obligors and thus cannot be considered substantially the same.

ARGUMENT

I. ALL EXCHANGES ARE REALIZATION EVENTS UNLESS THE EXCHANGED PROPERTIES REPRESENT THE SAME PROPERTY RIGHTS.

The Internal Revenue Code provides that increases or decreases in the value of property are to be taken into account for tax purposes when realized in a sale, exchange or other taxable event. Section 1001(a) of the Internal Revenue Code provides that

> [t]he gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized

26 U.S.C. § 1001(a). On its face, this section pronounces a sweeping rule: gain or loss "*shall be*" realized on *every* disposition of property.

The regulation promulgated under § 1001 adopts a narrower standard, by requiring that in a disposition by way of an exchange the exchanged assets must be materially different in order to trigger realization. Specifically, the regulation provides that "[e]xcept as otherwise provided . . ., the gain or loss realized from the conversion of property into cash, or from *the exchange of property for other property differing materially either in kind or in extent*, is treated as income or as loss sustained." 26 C.F.R. § 1.1001-1(a) (emphasis added). This regulation reflects the principle announced in the seminal decisions of this Court concerning realization that certain "exchanges" are

so devoid of a change in substance that no disposition of property—and thus no realization event—has really occurred.

In several early decisions interpreting the meaning of "income" under the Sixteenth Amendment, this Court addressed the application of the realization doctrine to exchanges of stock in the context of corporate reorganizations.[2] As one commentator observed,

> Because of the changes in the income tax law [after these Supreme Court cases], providing a statutory scheme for the taxation of reorganizations, no further cases involving the basic question of the realization of income under these conditions have come before the Supreme Court. This group of cases accordingly constitutes a unit, which affords perhaps the most fully developed discussion of the ideas of the Supreme Court as to the nature of income. It is clear [from these cases that] . . . there must have been some change in the form or the extent of the taxpayer's investment. *But there need be no substantial change in the character of the investment, if a formal change has occurred.*

R. Magill, *Taxable Income* at 77-78 (1945) (citations omitted) (emphasis added). FNMA concurs with the detailed discussion of these cases in respondent's brief to this Court and will comment only briefly on two of these cases that are especially pertinent here: *Weiss v. Stearn*, 265 U.S. 242 (1924), and *Marr v. United States*, 268 U.S. 536 (1925).

Weiss and *Marr* both concerned corporate reorganizations involving the exchange of stock in an old corporation for stock in a new corporation. In *Weiss*, this Court found that the exchange of stock in an Ohio corporation

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[2] *United States v. Phellis*, 257 U.S. 156 (1921); *Rockefeller v. United States*, 257 U.S. 176 (1921); *Cullinan v. Walker*, 262 U.S. 134 (1923); *Weiss v. Stearn*, 265 U.S. 242 (1924); *Marr v. United States*, 268 U.S. 536 (1925).

for stock in its reorganized successor, also incorporated in Ohio and continuing the entire business of the former, did not trigger realization: "Something more is necessary—something which gives the stockholder *a thing really different* from what he theretofore had." 265 U.S. at 254 (emphasis added).

A year later, *Marr* emphasized the extremely narrow scope of the nonrealization rule enunciated in *Weiss*. In *Marr*, the corporate reorganization involved a change in the state of incorporation of General Motors from New Jersey to Delaware. The new Delaware corporation took over the business of the old New Jersey corporation, and the latter was dissolved. Justice Brandeis, who had dissented in *Weiss*, wrote for the majority in *Marr*:

> In the case at bar, the new corporation is essentially different from the old. A corporation organized under the laws of Delaware does not have the *same* rights and powers as one organized under the laws of New Jersey. Because of these inherent differences in rights and powers, both the preferred and the common stock of the old corporation is [sic] an essentially different thing from stock of the same general kind in the new. . . . The case at bar is not one in which after the distribution the stockholders have the *same* proportional interest of the *same* kind in essentially the *same* corporation.

268 U.S. at 541-42 (emphasis added).[3] *Marr* thus limits the *Weiss* nonrealization rule to the very narrow circumstance where the taxpayer before and after the exchange has "in essence . . . the *same* interest." 268 U.S. at 541 (emphasis added).

The conclusion that flows from *Weiss* and *Marr* is that an exchange is a realization event unless the exchanged

[3] Although the Court also referred to other differences between the old and new stock, the language quoted above makes it clear that the difference in the state of incorporation was itself sufficient to render the old and new stock materially different.

properties represent the same property rights. Realization is not barred simply because the exchanged assets are of like kind, or likely to exhibit similar economic performance.[4] Rather, realization is barred only when there is such an identity between the exchanged properties that the taxpayer ends up with the same property rights with which he began.

This easily satisfied realization test not only honors the sweeping language of the Code, it provides predictability to taxpayers and makes for easy administrative application. *See* R. Magill, *Taxable Income* at 76-77 (1945). Virtually every transaction results in realization. To determine whether the realized gain or loss is taken into account—that is, "recognized"—for tax purposes, taxpayers and the courts need only consult the specific nonrecognition provisions that Congress has enacted. *E.g.*, 26 U.S.C. § 1031 (like-kind exchanges of certain properties not including evidences of indebtedness); 26 U.S.C. § 1091 (wash sales of securities).[5]

Petitioner suggests that the Fifth Circuit's decision in this case—that differences in obligors and collateral always produce material differences—effectively reads the word "material" out of the regulation and the tax law. The Fifth Circuit, however, was properly recognizing the breadth and "hair-trigger" nature of the realization doctrine and the narrow range of exchanges that do not re-

[4] The test that Petitioner suggests for determining whether mortgages are materially different, *i.e.*, whether they have the same "potential future performance," is erroneous and contrary to accepted principles of tax law. For example, in *Marr*, the stock exchanged did not represent the same property rights, but it was likely to exhibit identical future performance. Petitioner's suggested test is thus squarely at odds with the Court's decision in *Marr*.

[5] Petitioner does not contend that any nonrecognition provision is applicable to the R-49 transactions.

sult in realization. For example, under the Fifth Circuit's correct view of realization, an exchange of two different shares of the same class of IBM stock would not result in realization because they represent the same property rights; they are different but not materially different. Similarly, an exchange of stock for complete control of a voting trust whose sole asset is the identical stock would not result in realization because the taxpayer's property rights would be unchanged. There will, of course, be relatively few exchanges that fail to meet this test for realization, but this fully accords with the understanding of realization developed in the decisions of this Court discussed above.

Moreover, as for petitioner's concern about reading the material difference requirement out of the tax law, it is worth emphasizing that the Internal Revenue Code itself contains no such requirement. Because the Code imposes no limitations on the types of exchanges that result in realization, the "material difference" standard in the regulation is legitimate only to the extent it reflects the realization test that arises from *Weiss* and *Marr*. So long as, consistent with *Weiss* and *Marr*, the material difference standard requires only that the exchanged assets represent different property rights, then the regulation is justified by Supreme Court precedents. Such a requirement merely recognizes that if the exchanged assets represent the *same* property rights, then there has not really been any exchange. In contrast, if the materially different standard in the regulation were interpreted to bar realization whenever exchanged assets are of like kind or economically similar, then requiring a material difference for realization would contravene the language of § 1001(a) and constitute an unauthorized and improper legislative regulation. *See Helvering v. Credit Alliance Corp.*, 316 U.S. 107 (1942) (Treasury regulation not given effect where it was not only contradictory to plain terms of statute but also attempted to add a supplementary legislative provision).

II. THE MORTGAGES EXCHANGED IN R-49 TRANSACTIONS WERE MATERIALLY DIFFERENT: THEY DID NOT REPRESENT THE SAME PROPERTY RIGHTS.

In every R-49 transaction, the question whether the exchange of mortgages constituted a realization event should be resolved affirmatively as a matter of law. The mortgages exchanged had different obligors and were secured by different underlying properties; those factors alone render them materially different because they necessarily entitled their owners to different economic rewards and subjected them to different economic risks. The exchanged mortgages may have been of a like kind or economically similar, but they did not represent the same property interest, and thus a real exchange did occur. Given these essential differences between the exchanged mortgages, all 16 Tax Court judges and all nine court of appeals judges who considered this issue have properly concluded that the mortgage exchanges were realization events.[6]

The only reason that the R-49 cases are before this Court is the magnitude of the tax losses at issue. If in a year-end tax planning transaction, a taxpayer were to exchange a triple-A-rated bond of one issuer for a triple-A-rated bond of another issuer, with the bonds matched according to interest rate, principal amount and

[6] Although it was the only ground on which it prevailed in any of the R-49 cases, petitioner now essentially abandons any separate argument that § 165 of the Internal Revenue Code precludes the deduction of the losses incurred in R-49 transactions because such losses, even if "realized," were not "sustained." 26 U.S.C. § 165. In any event, as the District of Columbia and Fifth Circuits properly held, § 165 is not a bar to realization here. For a realized loss to be sustained, that section requires only that there be a closed and completed transaction, which even petitioner concedes was the case in each of the R-49 transactions. Moreover, the regulation at issue here concludes that, where (as here) there is no provision in the Code to the contrary, all realized losses are treated as sustained. 26 C.F.R. § 1.1001-1(a) (first and sixth sentences).

maturity date, we assume that the Internal Revenue Service would not dispute that the exchange was a realization event. Similarly, if Centennial and FNMA had exchanged a single mortgage of one obligor for a single mortgage of a different obligor, with the mortgages matched according to interest rate, outstanding balance and remaining term, we doubt the IRS would have disputed that the exchange was a realization event as to both taxpayers. That the R-49 cases involve substantial tax losses should not obscure the correct tax consequences arising from those transactions. As stated above, those consequences turn as a matter of law on the mortgages having different obligors and different underlying properties.

Because of these differences in obligors and underlying properties, there is no need for the courts to inquire into the particular facts of each R-49 transaction. Although unnecessary, a more detailed factual inquiry would only confirm the materiality of the differences between the mortgages exchanged. The record in the *FNMA* case provides a convenient vehicle for examining those facts—particularly because FNMA was the other party to the Centennial exchanges that are before the Court and because FNMA engaged in a greater number of R-49 transactions than any other taxpayer.

As petitioner notes, because the mortgages exchanged in an R-49 transaction were matched according to such criteria as interest rate, outstanding balance and remaining term, they would perform identically *if* they were all paid each month according to their terms. In this respect, mortgages are no different from bonds or any other debt obligation. As with any secured debt obligation, the central issue for any investor in mortgages is whether the mortgages will be paid according to their terms and whether each securing property is adequate to compensate if there is a default. Thus, in appraising whether the exchanged mortgages were materially different, the question is whether they have such an identity that they will necessarily exhibit the same delinquency, default and prepayment characteristics.

While the mortgages in an R-49 transaction were similar in some economic respects, petitioner cannot plausibly dispute that any two exchanged mortgages—or any two pools of exchanged mortgages—would not necessarily have the same performance with respect to delinquency, default and prepayment. As Dr. John P. Danforth, an economist who specializes in the savings and loan and banking industries, testified in the *FNMA* case:

> At the simplest level, no matter how identical two mortgage loans are at a given moment of time—even assuming that the properties are identical and adjacent and that the obligors have identical jobs, ages, incomes and health—the mortgage loans may behave differently; one house could burn down or develop termites or one homeowner could lose his job or die. Thus, while it may be impossible at one point of time to say how the two mortgage loans will differ—or which is the "better" loan—the individuality of the loans means *they are different economic assets.*

FNMA JA 380-81[7] (emphasis added).[8] It was thus predictable at the time of the transactions that the mortgages exchanged would perform differently. As Dr. Danforth explained:

> The fact that pools of mortgage loans, instead of individual mortgage loans, were purchased and sold does not alter this conclusion. Simply put, no matter how perfectly two pools of, say, 500 loans were matched, there can be no guarantee that they will

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[7] References in the form "*FNMA* JA ——" are to materials in the Joint Appendix filed in the *FNMA* case in the District of Columbia Circuit. We have lodged with the Clerk a copy of this Joint Appendix.

[8] Dr. Danforth was formerly Chief Economist for the Federal Reserve Bank of Minneapolis, where he also directed the banking studies program, and he is currently a consultant on matters relating to the banking and savings and loan industries. *FNMA* JA 378, 391. Dr. Danforth also gave expert testimony in the present case.

> have identical prepayment, foreclosure, and delinquency experience; indeed, it would be extremely surprising if they did.

FNMA JA 381.

This expert testimony also clearly refutes the statistical misconception underlying the revenue ruling that initially articulated petitioner's position on the R-49 transactions. *See* Rev. Rul. 81-204, 1981-2 C.B. 157. The revenue ruling maintained that the large number of mortgages exchanged somehow rendered the differences between the individual mortgages statistically insignificant. The central limit theorems (known colloquially as the "law of large numbers") guarantee no such result, and petitioner was apparently unable to locate an expert to testify in support of its theory. Thus, having adduced no factual or expert support for this theory, petitioner dropped the argument at the court of appeals level in the *FNMA* case.

Petitioner not only has failed to establish the validity of its statistical premise, it also has not addressed the practical difficulty of determining where courts should draw the line. Assuming that the exchange of one mortgage for another (or one bond for another in a typical year-end tax swap) results in realization, petitioner gives no principled basis for determining how many mortgages or bonds would have to be exchanged—2, 20, 200, or more—in order to bar realization.

Because the particular characteristics of the obligor and the underlying property influence the timing and extent of payments, and the extent of security in the case of foreclosure, no two mortgages or groups of mortgages will necessarily have the same performance. This lack of identity of property interests requires realization under the proper legal test described above. But, even if a broader exception to the realization rule were recognized (under which there would be no realization if the exchanged properties represented *virtually* the same property interests), realization would still be appropriate here.

While Dr. Danforth pointed out that mortgages or groups of mortgages would be likely to perform differently no matter how perfectly one attempted to match them, he emphasized that the R-49 criteria did not begin to match the exchanged mortgages in terms of the factors that were likely to bear upon their performances. In particular, Memorandum R-49 did *not* require that the exchanged mortgages be matched according to the following factors: the borrower's income, credit history, and employment status; the extent and existence of private mortgage insurance coverage; the condition of the property and whether it was owner-occupied; the identity of the mortgage servicer and any historical performance data relating thereto; the existence of a prepayment penalty; and mortgage assumability. *FNMA* JA 380-87, 542-46.

Differences with respect to these characteristics, not taken into account by Memorandum R-49, are likely to affect the economic performance of the mortgages (and are thus "material" for purposes of realization). Both Dr. Danforth and Robert J. Mahn, FNMA's Senior Vice President and Controller, so testified in the *FNMA* case (*FNMA* JA 381-83, 543-46), and we are aware of no testimony to the contrary in any other R-49 case. This testimony, moreover, was corroborated by the detailed underwriting guidelines that FNMA requires lenders to follow to become regular FNMA customers. These guidelines emphasize at length the need to inquire into factors such as those enumerated above when making mortgage loans, and FNMA's policy was to avoid engaging in secondary market transactions with lenders whose underwriting practices were not consistent with the guidelines. *FNMA* JA 234-60, 547-49.

Two of the differences among the mortgages exchanged in the R-49 transactions are so conspicuous and significant that they merit separate comment.

First, the mortgages exchanged in the R-49 transactions varied with respect to geographical distribution. Typically, a savings and loan institution's portfolio would principally consist of mortgages secured by property in its local area. When two such institutions exchanged mortgages, each would diversify its portfolio by obtaining mortgages from the other's local area. When one such institution exchanged mortgages with FNMA—which owned mortgages secured by properties spread throughout each state—even greater geographic diversity was achieved. For example, in FNMA's two transactions with Centennial, the properties securing the mortgages FNMA acquired from Centennial were located principally in the Dallas area whereas the properties securing the mortgages Centennial acquired from FNMA were dispersed throughout the state of Texas. *FNMA* Exhs. 64-BL(50) and 64-BL(51).

The location of the underlying property is material in at least two respects. For one thing, even if the different locations were economically identical, the geographical diversification of a mortgage portfolio over these different areas is of significance to lenders because it makes them less vulnerable to local disasters such as floods or tornados. *FNMA* JA 506.

Moreover, the locations of the underlying properties were not economically identical. Petitioner's contention that, because Memorandum R-49 required only that the properties be located in the same state, intrastate differences cannot be material makes no sense and is squarely belied by the record in the *FNMA* case. Dr. Danforth testified that intrastate differences can be very significant. *FNMA* JA 382-83. Using as an example FNMA's exchange with Newport News Savings and Loan Association, he contrasted the economic character of the Newport News, Virginia area, which was dominated by two employers, with nonurban areas of Virginia not so influenced by such narrow economic characteristics.

FNMA JA 692-94. Dr. Danforth also emphasized that, even if the mortgages' underlying properties were located in the same metropolitan area, they would still be far from comparable because "[c]ities, towns and even neighborhoods within the same metropolitan area can vary radically with respect to the mortgage risk they pose." *FNMA* JA 382-83. This point is confirmed by FNMA's own underwriting standards, which indicate that even differences in location within a city are significant and that location should in some cases be evaluated on a *block-by-block* basis. *FNMA* JA 250.

Second, in FNMA's transactions, the underlying properties also varied with respect to whether they were located in rural or urban areas. FNMA intentionally purchased many more urban mortgages than it sold. *FNMA* JA 420 at ¶¶ 111, 112. For example, in the transactions with Centennial, FNMA disposed of 29 urban mortgages and acquired 148 urban mortgages. *FNMA* JA 372. Undisputed expert testimony in the *FNMA* case indicated that different economic and demographic forces influence the urban and rural housing markets and are likely to lead to different performances for urban and rural mortgages. *FNMA* JA 383-88. As Dr. Danforth testified:

> [T]here have been marked cyclical swings of population between rural, urban, and suburban areas resulting from relative prosperity of those areas, transportation systems permitting or inhibiting commutation, and a host of other factors. These differences are likely to lead to different prepayment, delinquency and default experience for urban and rural mortgage loans.

FNMA JA 383. *See also id.* at 383-87. Thus, the properties underlying the mortgages exchanged by FNMA were not only from different areas, they were from different *types* of areas.

As the Tax Court found, in view of the many differences between the exchanged mortgages, FNMA expected them to perform differently. 90 T.C. at 412. In fact, they have performed substantially differently both on a transaction-by-transaction basis and in the aggregate:

- *Delinquencies.*—In every single transaction, the mortgages have had different delinquency rates; in the aggregate, the mortgages FNMA transferred have consistently displayed a lower delinquency rate than the mortgages it received (90 T.C. at 412-13; *FNMA* JA 311-60);
- *Foreclosures.*—In a substantial majority of the transactions, the mortgages have experienced differences with respect to the number and timing of foreclosures; in the aggregate, the foreclosure rate experienced on the mortgages FNMA transferred has been significantly higher than the foreclosure rate experienced on the mortgages it received (*id.*); and
- *Prepayments.*—In virtually every transaction, the mortgages have had different prepayment rates (*id.*); in the aggregate, the mortgages have had different prepayment rates (90 T.C. at 412; *FNMA* JA 361-65).

Petitioner wrongly criticizes the Fifth Circuit for considering the subsequent differing performances of the mortgages exchanged in assessing whether the mortgages were materially different. This criticism apparently rests on the false premise that the materially different standard embodies some sort of intent test and that subsequent performance could not be relevant to intent at the time of the transaction. As explained above, however, the standard is designed only to determine whether the exchanged assets were "really different"—whether they represented different property rights. If assets perform differently, then by definition they are really different and do represent different property rights. The post-transaction performance of the mortgages thus corroborates Dr. Danforth's view that it was

predictable at the time of the transactions that the exchanged mortgages would not behave identically, and it belies any suggestion that exchanging pools of mortgages as opposed to individual mortgages could somehow cancel out the differences. The use of subsequent history to corroborate decisions regarding tax treatment is proper. For example, courts have uniformly accepted evidence of subsequent loss experience to confirm the reasonableness of a taxpayer's additions to its bad debt reserve. *See, e.g., Westchester Development Co. v. Commissioner*, 63 T.C. 198, 212-13 (1974), *acq.* 1975-2 C.B. 2.

III. PETITIONER'S SUBJECTIVE APPROACH TO DETERMINING WHETHER DIFFERENCES ARE MATERIAL IS LEGALLY AND FACTUALLY UNSUPPORTED.

Petitioner argues that the parties to the R-49 transactions were unconcerned with the differences in the exchanged mortgage pools, that differences are not material unless they matter to the "marketplace," and that the mortgage pools were thus not materially different. Petitioner is wrong on both the law and the facts.

A. The Subjective Intent of the Parties to the R-49 Exchanges Does Not Demonstrate That There Were No Material Differences Between the Mortgage Pools.

FNMA does not quarrel with the initial premise that to be deemed "material" the differences between the mortgage pools must be of the sort that "matter." The critical question is how the test is applied. In the R-49 transactions, there is no question that the differences "mattered" in that the exchanged mortgage pools were expected to (and actually did) have materially different economic performances. Petitioner is wrong as a matter of law, however, in arguing that those differences must have mattered to the parties to the particular transaction

and must have been taken into account by the parties in deciding whether to enter into that transaction. Moreover, even this erroneous test is satisfied on the facts here.

1. *Petitioner Is Wrong on the Law.*

Petitioner's argument completely divorces the material difference test from the limited purpose that it properly serves. As explained above, this test does not arise from any concern about a taxpayer's motivation for effecting a transaction. Rather, it is designed to preclude realization of gain or loss when there is such an identity between the exchanged properties that the taxpayer ends up with the same property rights with which he began. For the purpose of this test, therefore, it is irrelevant whether the taxpayer cares (or even knows) that the properties are materially different. So long as they *are* materially different, the Internal Revenue Code requires that gain or loss be realized.

Petitioner's position is wholly unprecedented. In *Marr*, for example, the Court never inquired whether the taxpayers were indifferent to receiving new General Motors shares in exchange for their old shares; it focused on the objective characteristics of the old and new shares and held that the differences, as minor as they were, barred a finding that the shares were essentially the same. Petitioner points to no case in which a court considered the subjective views of the parties even as evidence of whether material differences existed.

Petitioner's theory is also unsound as a matter of tax policy. Under this theory, two taxpayers that engaged in different R-49 transactions could receive disparate tax treatment for their respective transactions. Indeed, it could lead to the perverse result that mortgage pools (or bonds with identical payment terms and credit ratings) exchanged between two parties in one transaction are materially different as to one party but not as to the

other.[9] In short, a decision by this Court based even in part on the subjective intent of the parties would result in continuing controversy regarding the proper tax treatment of the R-49 transactions and would create new controversies regarding the now-settled tax treatment of exchanges of bonds and other securities.

Of course, whether the differences mattered to the parties to the transaction may be of some relevance in determining whether they matter in general. But such evidence is by no means dispositive where, as here, other evidence indicates that the differences were material. This is especially so where, as here, the transactions offered significant collateral benefits that outweighed the likely gain or loss on the exchange. In the *FNMA* case, for example, the Tax Court found that FNMA's R-49 transactions (including the exchanges with Centennial) were motivated by several significant tax and nontax factors, including FNMA's desire: (a) to acquire urban mortgages in response to pressures from HUD to increase its urban mortgage holdings; (b) to increase the number of mortgages in FNMA's portfolio having enforceable due-on-sale clauses; (c) to broaden FNMA's customer base by developing relationships with savings institutions; and (d) to enhance the liquidity of the secondary mortgage market by facilitating the geographical dispersion of savings institutions' mortgage portfolios and helping ailing thrifts to recognize losses for tax purposes. 90 T.C. at 413-16. The Tax Court further found that FNMA "recognized that there were a number

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[9] Carried to its logical conclusion, petitioner's theory would even prevent realization of gain or loss where a taxpayer exchanged stock in Company A for stock in Company B, not because of the different earning potential of the stocks but because of such factors as (a) opposition to Company A's investment in South Africa or use of animals in testing, (b) the need to eliminate a conflict of interest, or (c) the obligation of a regulated company to invest only in companies on an approved list.

of significant differences between the mortgages that made it unlikely that they would behave the same economically" but that FNMA "accepted the risk that the mortgages would behave differently economically in order to receive the benefits that it derived from the transactions." *Id.* at 412.

2. *Petitioner Is Wrong on the Facts.*

The record in every R-49 case will demonstrate that, in general, characteristics of the obligors and underlying properties "matter" to the parties in the normal course of their business. Every mortgage originator that participated in an R-49 transaction considers these factors when deciding whether to originate a mortgage loan. As for FNMA, which does not originate mortgages but which regularly purchases them in the secondary market, the underwriting guidelines that it imposes on the institutions it deals with leave no doubt as to the significance it attaches to these factors. *FNMA* JA 234-60.

Even if the test were whether the differences were considered by the parties during the course of the transaction in question, the test would be satisfied here. First, as the Tax Court found in the *FNMA* case, a significant motivation for FNMA's participation in R-49 transactions (including the Centennial exchanges) was to obtain urban mortgages in exchange for rural mortgages. 90 T.C. at 413-14. FNMA was thus by no means indifferent to the properties underlying the exchanged mortgages. Second, the savings and loan associations were not indifferent to the mortgages' geographic distribution. The record in the *FNMA* case indicates that they desired the enhanced geographic dispersion of mortgages that the transactions offered. *FNMA* JA 423 at ¶ 126; JA 623. Third, the parties to FNMA's R-49 transactions did some review of the characteristics of the mortgages they were to acquire. For example, in the transactions with Centennial, FNMA's Dallas office prepared a written report on that association's portfolio, which concluded that the "portfolio consists of primarily Dallas Metroplex properties—FNMA's foreclosure experience in this area has been excellent." *FNMA* JA 30. FNMA thus expected that the mortgages being acquired would perform better than average because of the characteristics of the Dallas area. Similarly, Home Savings and Loan Association was concerned with the quality of the mortgages it would be receiving in its transaction with FNMA, and it planned to "spot check a sampling of [FNMA's mortgages] and the encumbered properties." *FNMA* JA 70.

B. The "Marketplace" Does Not Negate the Material Differences Between the Mortgage Pools.

Petitioner next argues that the differences between the exchanged mortgage pools were immaterial because the secondary mortgage market did not view these differences as material. Although not entirely clear from petitioner's brief, it would appear that this amounts to another subjective standard of materiality, based on the expert (and nonexpert) testimony of brokers and participants in the relevant market. This argument suffers from many of the same deficiencies as petitioner's first argument, *viz.*, (1) it ignores undisputed objective differences in favor of questionable subjective criteria, (2) it is inconsistent with the factual findings in the *FNMA* case, (3) it is unprecedented, and (4) it is unsound from a policy standpoint. In addition, a number of points unique to the "marketplace" argument can be made.

In support of its theory, petitioner relies on *Emery v. Commissioner*, 166 F.2d 27 (2d Cir. 1948). In fact, *Emery* focused on objective factors: the new Philadelphia bonds at issue in that case had substantially lower post-call interest rates than the old bonds transferred in the exchange; the new bonds matured from 1 to 23 years

earlier than the old bonds; and the new bonds had a shorter call period.[10]

Petitioner also relies on *Hanlin v. Commissioner*, 108 F.2d 429 (3d Cir. 1939). The court in that case applied an objective test in comparing Federal Land Bank bonds having different issuers and secured by physically different collateral. Contrary to petitioner's suggestion, *Hanlin* does not hold that subjective factors are determinative. The court referred to subjective factors *only* in the case of bonds issued by the same Land Bank and secured by the same properties (which the court held were substantially identical), and *not* in the case of bonds issued by different Land Banks and secured by different properties (which the court held—"by geographical definition"—were not substantially identical). *Hanlin, supra*, 108 F.2d at 431.

Finally, petitioner's argument is factually flawed. Because FNMA is the largest participant in the secondary mortgage market, its views as to whether differences between mortgage pools are material are highly relevant as to what is the "marketplace" view. As discussed above, the record in the *FNMA* case clearly establishes that the differences between the exchanged mortgage pools were material to FNMA and hence to the market in general.[11]

[10] *Emery* did note that the new bonds had a higher fair market value, which indicated a material difference. Petitioner mistakenly interprets *Emery* to require that the market subjectively view the exchanged assets as materially different. The references in *Emery* to fair market value, however, indicate only that the Philadelphia refunding plan involved an *uneven* exchange of bonds with different market values. An uneven exchange cannot involve essentially the same assets. In the typical *even* exchange, as in this case, the fair market values of the exchanged assets are always the same and are thus irrelevant to determining material differences.

[11] Petitioner takes issue with the Fifth Circuit's analogy to the exchange of two bonds issued by different corporations but having the same Moody's rating, the same interest rate and other terms, and the same value in the capital market. *See San Antonio Savings Ass'n v. Commissioner*, 887 F.2d 577, 590 (5th Cir. 1989), *petition for cert. filed*, No. 89-1928. Conceding that the two hypothetical bonds would be materially different, petitioner contends that the market would have evaluated the various differences between the bonds' issuers and taken those differences into account in setting the identical valuations. Ironically, under petitioner's theory of realization, such an exchange of bonds would present an even more difficult case for finding realization. The mortgages exchanged in the R-49 transactions were not matched to anywhere near the degree that bonds bearing the same Moody's rating have been. The differences between such bonds then would presumably be of less significance to the marketplace.

IV. PETITIONER'S RELIANCE ON MEMORANDUM R-49 IS MISPLACED.

The FHLBB staff's decision to permit thrift institutions not to record for regulatory accounting purposes losses incurred in R-49 transactions does not control the tax treatment of those transactions. *See Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979) (the characterization of a transaction for financial accounting purposes need not be the same as for tax purposes). Petitioner seeks to sidestep this settled principle by making the untenable claim that it relies only on the FHLBB staff's factual finding that the mortgages were substantially identical, not on the accounting result that follows from that finding. The "substantial identity" finding, however, did not exist in the abstract; the finding was that the mortgages were substantially identical for regulatory accounting purposes.

Moreover, even if the accounting and tax treatment of the transactions should be the same, that begs the question of which way they should both be treated. If anything was wrong with the attempt to differentiate the accounting and tax treatment of the transactions, it was the determination that no loss need be recognized for accounting purposes. Petitioner attempts to portray R-49 as a mischievous ploy to affect the tax consequences

of transactions. In fact, the records in all the cases are clear that everyone assumed that tax losses would be realized on these transactions. The controversial issue was whether the FHLBB could somehow permit the thrifts not to recognize the losses for regulatory accounting purposes. For better or worse, the FHLBB staff strained to permit the nonrecognition of losses for that purpose. But whether it was prudent to do so or not, the tax treatment of the transactions is unaffected.

Moreover, Memorandum R-49 has been nullified by the issuance earlier this year of Statement of Position ("SOP") 90-3 by the Accounting Standards Division of the American Institute of Certified Public Accountants ("AICPA").[12] SOP 90-3 states that exchanged pools of single-family mortgages are not to be considered substantially the same because the exchanged mortgages do not have the same primary obligor, and it clarifies that losses from such exchanges should be reported for financial accounting purposes. Thus, the tax and accounting regimes are now in accord: both regimes require that losses be recognized on R-49 transactions.

Finally, if the FHLBB staff, in developing Memorandum R-49, wanted to develop a list of criteria that would eliminate material differences between the exchanged mortgages, the records in these cases show that it failed badly. The uncontroverted evidence in the *FNMA* case reveals that Memorandum R-49 did not require the exchanged mortgages to be the same with respect to *any*, much less *all*, of the factors that bear on prepayments, delinquencies and foreclosures. Robert J. Mahn (FNMA's Senior Vice President and Controller) and Dr.

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[12] Regulatory accounting standards set by federal thrift regulators now must follow generally accepted accounting principles ("GAAP"), one source for which is AICPA statements of position. 12 U.S.C. § 1463(b)(2)(A). The authoritative GAAP interpretation now found in SOP 90-3 (a copy of which is lodged with the Clerk) did not exist when Memorandum R-49 was issued.

Danforth both testified that the R-49 criteria did not represent nearly a complete list of factors normally considered when underwriting a loan; indeed, they had virtually nothing to do with underwriting criteria. *FNMA* JA 380-87, 515-16, 542-48, 687-89. Given this fact, and the widely differing performance of the exchanged mortgages, any deference that the courts should give to the FHLBB staff's position is clearly outweighed by the competing evidence.

CONCLUSION

The judgment of the United States Court of Appeals for the Fifth Circuit should be affirmed with respect to the mortgage exchange issue.

For the reasons discussed above, FNMA submits that every taxpayer realized losses on every R-49 transaction because, as a matter of law, the mortgages exchanged in those transactions differed materially with respect to their obligors and underlying properties. But if this Court decides that realization of losses depends on a more detailed examination of the particular exchange, then it should craft its decision in this case in such a way as to permit other R-49 cases to be decided on their own facts.

Respectfully submitted,

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BRIEF

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Supreme Court of the United States

October Term, 1990

UNITED STATES OF AMERICA,

Petitioner,

v.

CENTENNIAL SAVINGS BANK, FSB
(RESOLUTION TRUST CORPORATION, RECEIVER),

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

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QUESTIONS PRESENTED

1. Whether a loss in market value of mortgage loan receivables is deductible for income tax purposes where the owner transfers complete ownership of the mortgages (or 90 percent interests in the mortgages) to an unrelated party in exchange for similar mortgage loan receivables.

2. Whether income received by a financial institution from its depositors as a result of customers' premature termination of time deposit accounts is properly classified as income from discharge of indebtedness within the meaning of Section 108 of the Internal Revenue Code.

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No. 89-1926

In The

Supreme Court of the United States

October Term, 1990

UNITED STATES OF AMERICA,

Petitioner,

v.

CENTENNIAL SAVINGS BANK, FSB
(RESOLUTION TRUST CORPORATION, RECEIVER),

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

AMICUS CURIAE BRIEF OF THE UNITED STATES LEAGUE OF SAVINGS INSTITUTIONS IN SUPPORT OF RESPONDENT

SCOPE OF THIS BRIEF

This brief addresses both issues in the instant case. It also discusses the exchange of mortgages issue in the companion case before this Court, *Cottage Savings Association v. Commissioner*, 890 F.2d 848 (6th Cir. 1989) ("Cottage Savings"), *rev'g* 90 T.C. 372 (1988), *cert. granted*, 111 S.Ct. 40 (1990), and in the other Fifth Circuit and District of Columbia Circuit decisions whose certiorari petitions are pending before the Court: *San Antonio Savings Association v. Commissioner*, 887 F.2d 577 (5th Cir. 1989) ("San Antonio"), *aff'g* 55 T.C.M. 813 (CCH) (1988), *petition for cert. filed*, No. 89-1928 (June 8, 1990); *First Federal Savings and Loan Association of Temple v. United States*, 887 F.2d 593 (5th Cir.

1989) ("First Federal"), *aff'g* 694 F. Supp. 230 (W.D. Tex. 1988), *petition for cert. filed*, No. 89-1927 (June 8, 1990); and *Federal National Mortgage Association v. Commissioner*, 896 F.2d 580 (D.C. Cir. 1990) ("FNMA"), *aff'g* 90 T.C. 405 (1988), *petition for cert. filed*, No. 89-1987 (June 19, 1990).

INTEREST OF THE U.S. LEAGUE OF SAVINGS INSTITUTIONS AS AMICUS CURIAE

The United States League of Savings Institutions ("U.S. League") is the nationwide trade association representing the interests of savings institutions. Those institutions serve the nation's housing finance, savings and related financial service needs. Its membership as of June 28, 1990, includes 2,374 savings and loan, savings bank and cooperative bank institutions from every State, the District of Columbia, Puerto Rico, the Virgin Islands and Guam; 30 savings and loan holding companies; 165 associate members (typically law, accounting and other supplier firms to the industry); and 60 state and regional organizational members.

The U.S. League represents the collective views of its members before Congress, the executive branch of government, federal regulators and other appropriate bodies. On occasion it participates as *amicus curiae* in litigation of widespread interest and significance to its membership. Many members of the U.S. League which are not in receivership are involved in pending tax audits and litigation in the Tax Court and other courts around the country involving both issues in the instant case.[1]

SUMMARY OF THE ARGUMENT

Exchanges Of Mortgages

1. This Court should uphold Centennial's loss deductions, and the loss deductions claimed by the taxpayers in *Cottage Savings* and in the related decisions being held by the

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[1] The parties in the instant case have consented in writing to the filing of this brief amicus curiae. *See* Sup. Ct. R. 37. The written consents have been filed with the Clerk of the Court.

Court. If the Court chooses to adopt the "differing materially" language of Treas. Reg. § 1.1001-1(a) as the governing tax criterion for the losses claimed, the Fifth Circuit and the District of Columbia Circuit were legally correct in holding that the different obligors and collateral underlying each mortgage exchanged rendered all of the mortgages materially different from each other.

However, the preferable rationale for the Court to use in upholding the deductions is neither (1) the Fifth Circuit and D.C. Circuit's rationale, nor (2) the Government's position that realization of gain or loss turns on whether the parties "changed their economic positions" as a result of the exchange or "perceived" that they were changing their economic positions.

The Court should endorse the analysis made by several judges in the lower courts that the "differing materially in kind or in extent" language of Treas. Reg. § 1.1001-1(a) is not the proper tax test of realization of gain or loss at all. The historically more accurate rule is that realization occurs on every exchange of property for other property in kind unless the properties exchanged are so similar that they represent the identical property rights. It is immaterial for this purpose whether the property which the seller receives is similar in nature, similar in economic risks, similar in the market forces that affect it, or similar in market value to the property transferred. It is also immaterial for realization purposes how the parties to the exchange "perceived" their overall economic position as affected by the exchange. These are the historical first principles of realization.[2] The Government's theory will be difficult to administer and will even hurt its own revenue-collecting interests.

2. The Government[3] does not mention that the exchanges of mortgages by thrifts and by FNMA resulted

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[2] For further discussion of the material difference criterion, and a recommendation for replacing it along the lines suggested herein, see Bacon, *S&L Loan Swaps at the Supreme Court: Ripple Effects*, 49 Tax Notes 1121 (Dec. 3, 1990).

[3] References to the Government's position are to its brief filed herein. Brief for the U.S. in *United States v. Centennial Savings Bank*,

(Continued on following page)

only in a deferral of taxes and not in permanent escape from taxes. The income of the industry offset by the loss deductions in 1980 and 1981 is currently being "repaid" by the thrifts (and by FNMA) over the term of the mortgages acquired in the exchanges. Therefore, the only amounts at stake for IRS involve interest on the deficiencies asserted by IRS for 1980 and 1981.[4]

3. The Government is attacking the deductibility of *losses* claimed by the taxpayers, but the principles proposed by the Government to deny the deduction of losses apply equally to *gains* and to the possibility that taxpayers may use the Government's own argument (no realization if there is no change in economic position) to claim that exchanges of similar properties at a gain are not taxable events.

4. The Government concedes that there is no *nonrecognition* provision of the Code that applies to disallow the claimed deductions (such as the "like kind" exchange rule in Section 1031 or the "wash sale" rule in Section 1091).[5]

5. The Government effectively concedes that the Sixth Circuit erroneously rationalized its holding under Section 165 (relating to the allowance of loss deductions generally) in denying the loss deductions in *Cottage Savings*.

(Continued from previous page)

FSB (Resolution Trust Corporation, Receiver), Case No. 89-1926 [cited hereafter as "Gov't Brief"].

[4] Bacon, *supra* note 2, at 1125.

[5] References to "the Code" are to the Internal Revenue Code of 1954 as in effect during 1980 and 1981 when the exchanges of mortgages by Centennial, and other thrifts and FNMA, took place. Sections referred to herein are to the 1954 Code. The relevant sections of the Code at issue in these transactions, particularly §§ 165 and 1001, are identical under the Internal Revenue Code of 1986.

Certificate Of Deposit Issue

Two central facts warrant affirmance of the Fifth Circuit on this issue. First, there was only a single relationship of debtor/creditor, respectively, between Centennial and holders of its time deposit accounts. Second, the deferral permitted by Section 108 is not limited to financially troubled companies or to circumstances where the debtor and creditor negotiate at the time of the discharge. The "penalty" terminology used in banking regulations was intended to serve only a banking purpose of informing the depositor concerning the effect on him of an early withdrawal; it is not intended to characterize the transaction from the debtor's standpoint. More importantly, the banking regulation does not control the application of income tax rules. As a result, Centennial's repayment to its depositors of less than the full amount of principal and/or interest otherwise due them constitutes income from discharge of indebtedness which may be deferred under Section 108.

ARGUMENT

I. THE LOSS DEDUCTIONS CLAIMED BY CENTENNIAL FROM EXCHANGING MORTGAGE LOANS WERE ALLOWABLE AND SHOULD BE UPHELD, BUT ON A RATIONALE MORE HISTORICALLY CORRECT THAN THE "DIFFERING MATERIALLY" LANGUAGE OF TREAS. REG. § 1.1001-1(a).

A. The "Material Difference" Language Applied By The Fifth Circuit And The D.C. Circuit Affects A Wide Variety Of Business Transactions.

Several of the judges and lower courts in the cases on the mortgage exchange issue questioned whether the Fifth Circuit and D.C. Circuit used the correct rationale to uphold the loss deductions. The Fifth Circuit in the instant case (referred to herein as "*Centennial*") and the D.C. Circuit in *FNMA* upheld the deductions on a narrow rationale that the mortgages "differed materially in kind or in extent" from each other within the meaning of Treas. Reg. § 1.1001-1(a) because each of the mortgages carried different obligors and real estate

collateral.[6] The Fifth Circuit, which provided the fullest statement of its views in its *San Antonio* opinion, noted also that the material difference criterion applies both to exchanges where the obligors (or issuers) differ, and to "debt modification" cases where the obligor is the same but the terms of the debt are changed. 887 F.2d at 585. The Sixth Circuit in its *Cottage Savings* opinion, District Judge Walter Smith in his opinion in *First Federal*, and Judge Mary Ann Cohen in the Tax Court (with three concurring judges) concluded that realization of gain or loss does not depend on comparing the degree of change between the property rights involved in an exchange or comparative economic features of the properties exchanged. Instead, they concluded, gain or loss is realized simply by reason of a complete termination of the property rights transferred, regardless of the features of the property or rights received by the taxpayer in the exchange.

The Government in its brief does not fully acknowledge that this threshold question was raised in the lower courts. The Government may believe it can more easily persuade this Court to accept its highly unusual theory of realization if the Court views the exchange through the ambiguous "material difference" language of Treas. Reg. § 1.1001-1(a). The ambiguities are these: if material difference in kind or extent is the proper test, what features are material? How much change is material? From whose viewpoint is the change measured?

It will be hard for the Court to avoid addressing the legal validity of "material difference" as a test of realization from a sale or exchange of property in kind, and from other transactions where this "test" has been applied by the courts and by the Internal Revenue Service ("IRS"). The reason lies in the

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[6] The relevant provision of Treas. Reg. § 1.1001-1(a) reads as follows:

> Computation of gain or loss. – (a) General Rule. Except as otherwise provided in Subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

potential ramifications beyond the facts of this case if the Court retains "material difference" as a single all-purpose test of realization of gain or loss from an exchange and accepts *either* the more limited application of that test by the Fifth and D.C. Circuits *or* the Government's "economic" definition. The Government's proposed theory of realization is not limited to the facts of Centennial's case but applies potentially throughout the Internal Revenue Code.

As the Fifth Circuit suggested, the "material difference" language of Treas. Reg. § 1.1001-1(a) has become the touchstone for identifying a realization of gain or loss, and other tax consequences, in a wide variety of debt workouts, acquisitions, and other kinds of exchanges. In these situations interest rates are changed or deferred, principal amounts reduced or increased, maturity dates stretched or shortened, collateral substituted, liability assumed by a different obligor, co-debtors added, par values or voting rights changed, claims subordinated to other claims, and similar revisions negotiated. These kinds of changes occur in a long list of transactions.[7] Numerous cases and published and private rulings on these

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[7] These include loan restructurings between banks and third world countries, "workouts" by banks and thrifts of their nonperforming loans, debt refinancings between a financially troubled company and its banks and trade and bond creditors, assumptions of liabilities in real estate sales, reissuances of tax-exempt bonds, dispositions of installment obligations, changes in the terms of stock or debt obligations in corporate acquisitions, exchanges of partnership interests, divisions and mergers of trusts, divisions of jointly-owned property and settlements of disputes.

The Revenue Reconciliation Act of 1990 enacted a new § 108(e)(11) creating cancellation of indebtedness income for a debtor company that "issues" a debt instrument in satisfaction of indebtedness. Pub. L. No. 101-508, § 11325, 104 Stat. 1388 (1990). The committee reports state that this new rule will come into play only if the issuance of a new debt obligation for an existing debt obligation "qualifies as a realization event under section 1001 for the holder." 136 Cong. Rec. H12607, H12729 (Oct. 26, 1990).

various other transactions where the "material difference" language is applied have been collected by commentators.[8]

In many of these other kinds of transactions the effect of one party assuming the liability on an existing debt obligation is to change the obligor (as occurred in the exchanges here). A creditor's agreement with his debtor to substitute different collateral for the debt parallels the fact that here the thrifts and FNMA received mortgages having new collateral (as well as new obligors) compared to the receivables they transferred. The lower courts here thought that different obligors and collateral were material because "a misfortune affecting one family or one property could affect what happens to that obligation without affecting any of the other obligations." *Cottage Savings*, 90 T.C. at 395. Yet there are other types of transactions not involving an actual exchange where changing obligors or collateral on a debt obligation is considered not material.[9] The potential, therefore, is for the Court's decision

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[8] *See* Kalteyer, *Real Estate Workouts – Original Issue Discount Implications of Troubled Debt Restructurings*, 43 The Tax Lawyer 579, 628-35 (1990); Burstein, *Federal Income Taxation of Debt Swaps and Modifications*, 17 J. Corp. Tax'n 3 (1990); Henry, *Reissuance Revisited*, 42 Tax Notes 91 (1989); Rosen and Conway, *Leveraged Restructurings: Treatment of the Cash*, 66 Taxes 987 (1988); Banoff, *Tax Aspects of Real Estate Refinancing and Debt Restructuring: The Best and Worst of Times*, 64 Taxes 926, 940-61 (1986); Sheffield, *Holding Company Formations*, 64 Taxes 846 (1986); and Winterer, *Reissuance and Deemed Exchanges Generally*, 37 The Tax Lawyer 509 (1984).

[9] For example, a buyer's assumption of a debt obligation in a purchase or exchange of property does not alone give rise to original issue discount ("OID") or imputed interest. § 1274(c)(4). Nor is an installment note considered disposed of if the buyer sells the note to a third party who assumes the obligation to the original seller. Rev. Rul. 75-457, 1975-2 C.B. 196. A change in obligors does not trigger denial of interest deductions on certain bearer bonds. Treas. Reg. § 1.163-5(c)(2)(i). *See also Silverstein v. United States*, 419 F.2d 999 (7th Cir. 1969) (no sale or exchange where remainderman assumed the trust's obligation to pay income to the beneficiary), *cert. denied*, 397 U.S. 1041 (1970). As to changes in collateral, see Rev. Rul 55-5, 1955-1 C.B. 331 (no disposition); Rev. Rul. 77-416, 1977-2 C.B. 34 (substituted security allowed).

to affect a change in obligors and collateral in many other kinds of transactions.

The decision here may also affect the application of the material difference test to determining realization of gain or loss, and other tax effects, when other changes in terms occur.[10] The material difference test can apply either where an actual exchange occurs or where the question is whether changes in terms should be treated as if an actual exchange had occurred.[11]

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[10] In some transactions the Code refers to an "issuance" or "disposition" of an obligation. In these situations the courts and IRS apply the same, or a very similar, material difference test in deciding whether a new obligation has been issued for an old one or whether a change in terms amounts to a disposition of an old note. *See* Rev. Rul. 56-654, 1956-2 C.B. 216 (changes in the terms of preferred stock were "substantial" enough to be a constructive recapitalization). The cases and rulings dealing with dispositions of installment obligations under § 453B also do not explicitly apply the regulations under § 1001 but apply a similar test of whether the changes materially alter the seller's rights. *See* Rev. Rul. 82-122, 1982-1 C.B. 80.

As noted in the articles cited in footnote 8 *supra*, the tax effects which modifications of agreements and exchanges of similar properties can bring into play are varied: whether gain or loss must be reported by a bondholder or creditor as a result of a negotiated workout, or by a creditor or shareholder in a corporate recapitalization or acquisition; cancellation of indebtedness income and OID deductions for a debtor; loss deductions or OID income to creditors; taxation of gains as part of a reorganization or as an ordinary dividend; possible loss of tax-exempt bond status; acceleration of taxes on installment sale profits; and many others.

[11] For example, if a debtor in a workout actually issues a new bond or note to replace his existing bond, the question is whether the change in terms is "material" enough to cause gain or loss to be realized from the exchange. If, however (as frequently occurs), the terms of an existing obligation or contract are modified without formal execution of a new instrument, the issue becomes whether the changes are material enough so that the tax law should *deem* that an exchange, disposition, or issuance of new debt for old debt, or of new stock for old stock, etc., has occurred to which tax consequences then attach. Rev. Rul. 73-160, 1973-1 C.B. 365.

Although the Fifth Circuit thought that the cases and rulings applying the "material difference" test are well-developed (*San Antonio*, 887 F.2d at 587), commentators have called the same authorities inconsistent, underdeveloped and confused.[12] The courts and IRS have developed no real rationale as to why a change in terms is material in one situation but not in another. When the interest rate on a debt obligation is changed and the maturity date is extended, the courts have reached inconsistent results concerning whether gain or loss is realized.[13] Some courts have been less inclined to find material difference where the debtor is financially troubled than where he is healthy.[14]

Against this background, if the Court should agree with the Fifth Circuit and D.C. Circuit that the mortgages differed materially from each other because of the different homeowners and real estate, it would be necessary for the Court to consider whether the same conclusion should be reached in every kind of exchange where obligors and/or collateral change and, if not, what rationale justifies different results. Similarly, the Court's analysis could lead to unintended tax effects for the application of a single, all-purpose "material difference" test to other changes in the terms of stocks, bonds and other property interests.

We submit that the Court should uphold the thrifts' deductions here and in the related cases, but should clarify the law so that gain or loss from an exchange occurs whenever the taxpayer completely terminates his ownership rights to the property sold or changes his property rights in that property. This easily satisfied test would open the way to dealing with

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[12] *See, e.g.*, Kalteyer, *supra* note 8, at 629 (inconsistent); Banoff, *supra* note 8, at 952 (underdeveloped and confused).

[13] Compare *Watson v. Commissioner*, 8 T.C. 569 (1947) (realization) *and Girard Trust Co. v. United States*, 166 F.2d 773 (3d Cir. 1948) (realization) *with Mutual Loan and Savings Co. v. Commissioner*, 184 F.2d 161 (5th Cir. 1950) (no realization).

[14] See cases cited in Kalteyer, *supra* note 8, at 631-32.

the diverse types of transactions across a wide business spectrum where similar timing questions arise.

B. "Material Difference" Is Not The Historically Correct Criterion For Upholding The Loss Deductions.

In light of its origin and its placement in the current tax regulations, the Fifth and D.C. Circuits should have treated the material difference language as a relic of earlier times before the tax law and the courts distinguished between the concepts of *realization* and *recognition* of gain or loss. The references to "material difference" in Treas. Reg. § 1.1001-1(a) and to the "extent" of differences connote policy judgments concerning when to require an actual current reporting of income or deduction of loss. In short, they connote recognition and nonrecognition policies. The Government concedes in this case that no specific nonrecognition provision of the Code applies here to disallow Centennial's deduction. Yet it is to the nonrecognition provisions, if any, that the Government must look to support its "economic" analysis of the deduction issue because those provisions express Congress' policy judgments toward the timing of income (or deductions) for exchanges of properties which are economically similar or economically different from each other.[15]

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[15] For example, see § 1091 (nonrecognition of loss from sale and acquisition of "substantially identical" stocks or securities), § 1031 (nonrecognition of gain or loss from exchange of certain "like kind" real or personal property) and §§ 354 and 368 (nonrecognition of gain or loss from certain exchanges of stock or assets for other stock or assets in a reorganization). Section 1036 provides nonrecognition of gain or loss on exchanges of stock of the same class in the same corporation. This implies that realization occurs on an exchange of similar assets. Professor Boris Bittker has made the point that tax policy toward exchanges of economically similar assets is expressed through the recognition and nonrecognition provisions of the tax law:

> In effect, the nonrecognition provisions further defer tax consequences when, notwithstanding an exchange, the

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1. The Early Supreme Court Cases On Common Law Exchanges Intertwined The Concepts Of Realization And Recognition.

The language of Treas. Reg. § 1.1001-1(a) has descended, in one form or another, from the five Supreme Court cases cited in *San Antonio*, 887 F.2d at 583-85, decided between 1921 and 1925. These decisions dealt with the taxability of exchanges in corporate reorganizations that occurred during years before the tax statute (in 1918 and in 1921) first contained specific provisions on reorganizations and before it distinguished between *realization* of gain or loss from a sale or exchange and *recognition* of gain or loss. In these common law cases, the Court struggled to decide whether to require reporting of taxable gain by shareholders when their company transferred its assets (or when shareholders transferred their stock) to a new corporate entity formed in the same state or in a different state. Different justices attached varying significance to different state laws governing the old and new corporations, to changes in the terms of the old and new stock, and to changes (or lack of

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taxpayer maintains a continuing interest in similar property. This link between the realization concept and the nonrecognition provisions is most striking when the "sale or other disposition" of the original property is purely formalistic, so that the new property does not alter the taxpayer's economic status. An example is where an individual proprietor incorporates a going business, taking back 100 percent of the stock of the newly organized corporation. Nonrecognition can also be envisioned as a refinement of the realization concept if property is exchanged for other property that, although different in some respects, is subject to substantially identical economic risks (e.g., the exchange of agricultural property for similar property in the same geographical area).

2 B. Bittker & L. Lokken, Federal Taxation of Income, Estates and Gifts, 44-4 (2d ed. 1990) [cited hereafter as "Bittker & Lokken"]. *See also Century Electric Co. v. Commissioner*, 192 F.2d 155, 159 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1952).

changes) in the underlying business assets.[16] In four of the cases the Court found that gain from the exchanges should be taxed currently, but reached inconsistent results where a company reincorporated within the same state so that only its corporate shell changed.[17] Where only the state law changed, and no change occurred in the class or terms of shares transferred and received by the shareholders, the Court described the stock in the successor company as "having property rights and interests *materially different* from those incident to ownership of stock in the old company."[18]

Scholars and students of these old cases have pointed out that the justices were really disagreeing over basic policy toward the definition of income and how quickly income should be subjected to tax. The justices who wanted early taxation stressed formalistic factors such as a change in state law governing the predecessor and successor corporations (labeling such a change "material"). Other justices believed that no tax should be imposed where the underlying business assets of the corporation were not changed.[19] The criteria set forth by the Court were never clearly defined, and the inconsistent decisions are probably best explained by the majorities

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[16] The Court found that gain had been realized in the following cases: *Marr v. United States*, 268 U.S. 536 (1925) (reincorporation to different state law plus changes in dividend rate and voting rights between old and new preferred stock); *Cullinan v. Walker*, 262 U.S. 134 (1923) (spinoff and change in state of incorporation of parent company; creation of holding company); *Rockefeller v. United States*, 257 U.S. 176 (1921) (spinoff of one business to a new company formed in the same state); and *United States v. Phellis*, 257 U.S. 156 (1921) (reincorporation in different state). The Court held that gain was not realized in *Weiss v. Stearn*, 265 U.S. 242 (1924) (shareholder exchanged stock for stock of a new corporation incorporated under the same state law).

[17] The Court found no realization in *Weiss v. Stearn* where both corporations were formed under the same state law, but held in *Rockefeller* that gain was realized in the same circumstance.

[18] *United States v. Phellis*, 257 U.S. at 173 (emphasis added).

[19] *See* Magill, *Realization of Income Through Corporate Distributions*, 36 Colum. L. Rev. 519, 551 (1936).

that could be formed around the views of the individual justices who wrote the different opinions.[20] Randolph Paul, a leading scholar of these common law decisions, summed them up by observing: "The strain involved in reaching desired results was constantly apparent. Rationalization was hard at work to put desired results in acceptable legalistic form. The result was complete confusion."[21] The basic reason for confusion was that the justices who wanted early taxation of gains were, in part, expressing policy views that later became the *recognition* concept in the tax law. Two conceptual threads were thus intertwined in the five common law cases: realization and recognition of gain or loss. The Fifth Circuit in *San Antonio* did not make this separation. That fact seems to explain why it refused to view these common law cases as establishing that a formal disposition of property rights is all that is required for realization to occur. 887 F.2d at 585.

2. The Only Test For Realizing Gain Or Loss Is Whether The Seller Terminated Or Changed His Property Rights In The Property Sold.

Phellis through *Marr* represent the working out of two separate but related tax concepts: (1) a policy not to tax

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[20] In the decisions where gain was held realized, Justice Pitney authored the majority opinions in *Phellis* and *Rockefeller*, and Justice Brandeis authored the majority opinion in *Cullinan* and *Marr*. The principal dissenters in the latter two cases were Justices McReynolds and Van Devanter. In *Weiss v. Stearn*, where gain was held not realized, Justice McReynolds authored the majority opinion over the dissents of Justices Brandeis and Holmes. The often-quoted "test" from *Weiss* that an exchange must give each seller "a thing really different from what he theretofore had," 265 U.S. at 254, blurred rather than helped clarify the distinction later drawn in the tax law between realization and recognition of gain or loss.

[21] R. Paul, *Studies in Federal Taxation: Third Series* 18 (Harv. Univ. 1940). To the same effect, see the views of Prof. Roswell Magill in his book, *Taxable Income* at 76-80 (rev. ed. 1945). The same statement of Prof. Magill's views appears in his earlier article in Columbia Law Review, *Realization of Income Through Corporate Distributions*, 36 Colum. L. Rev. 519, 551 (1936).

annual appreciation in the value of business assets, i.e., the *realization* requirement, and (2) policy decisions embodied in the tax rules for recognizing or not recognizing gain or loss. In the old reorganization cases, fixing on the formality of a sale or exchange of the stock or assets as the time for *realizing* gain or loss was also "nicely adapted to the necessities of tax administration" – it made the tax collection process easy to administer by creating a bright line which is admittedly arbitrary.[22] *See* Magill, *supra* note 19, at 553. The formality of a change in state law was thus enough to trigger current tax in four of the five reorganization cases. The earliest predecessor of Treas. Reg. § 1.1001-1(a) required "essential difference" between the properties involved in an exchange in order for gain or loss to be realized, but found that test satisfied where stock was exchanged for a Liberty bond because "the conversion is into independent property having a market value." Treas. Reg. 45, Art. 1563 (1920), quoted by the Tax Court in *Cottage Savings*, 90 T.C. at 390-391 n.13.

The *realization* thread deriving from *Phellis* through *Marr* is thus that the formality of a sale or exchange of property controls and built-in gain or loss is realized when an exchange terminates each party's beneficial ownership rights in the property disposed of (such as a mortgage) by transfer to an unrelated person. There must necessarily be no under-the-table plan for the seller or a related person to reacquire the identical asset. It also follows that for realization purposes it is immaterial whether each party receives back property similar in kind or subject to similar economic risks or market forces as the property he transferred. It is necessarily also immaterial, contrary to the Government's arguments herein, whether Centennial "knew" or "cared" about the characteristics of the mortgages it received compared with those (which it knew well) of the mortgages it transferred.[23]

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[22] *See* Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 Ill. L. Rev. 779, 784 (1941).

[23] The fact that realization occurs on this type of hair trigger is hardly novel; IRS usually insists on such a test where taxable gains are

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The policy thread in the "confusion" created by *Phellis* through *Marr* underlies Randolph Paul's observation that "Congress came gallantly to the rescue with legislation."[24] He was referring to the Revenue Acts of 1918 and 1921, which created the first policy rules for *nonrecognition* of gain or loss from a corporate reorganization. These rules satisfied those who believed that a reincorporation or similar reorganization is not a desirable time to impose tax or allow loss deductions. Thus, today, as a policy decision, the reincorporations and other transfers involved in *Phellis* through *Marr* generally receive nonrecognition treatment as reorganizations under the Code. *See* Sections 354, 355, 361 and 368. These are the places to make policy judgments about whether differences between properties in an exchange are "material" or whether (as the Government argues here) Centennial's "economic position" changed as a result of its exchange with FNMA. The nonrecognition provisions in the tax law thus "describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial." Treas. Reg. § 1.1002-1(c). District Judge Smith correctly says in *First Federal* that the IRS has a recognition problem rather than a realization problem with mortgage exchanges. 694 F. Supp. at 241-242.

As the Code has developed an increasing number of specific nonrecognition provisions, the phrase "differing materially in kind or in extent" – which originally straddled both realization and recognition – has become an anachronism. Its original job was long ago divided between the separate tax concepts of realization and recognition of gain or loss. Consistent with this division of labor, the historically correct analysis is that *realization* occurs on every sale or

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involved. It was the Government that argued for recognition of *gain* in *Phellis* through *Marr*. In the instant cases, where the taxpayers want to deduct losses, the Government is simply reversing gears.

[24] R. Paul, *supra* note 21, at 18.

exchange if the seller terminates his ownership of the property or property rights transferred and does not thereafter own (or, by prearrangement, reacquire) the identical property rights. If the transaction involves a change in terms of a contract right or debt obligation, gain or loss should be considered realized if the taxpayer's property rights are changed in any way, regardless of the degree of change.[25] *How much* difference between the properties transferred and the property or contract rights received in the exchange ought to trigger current tax (or a loss deduction) is the province of tax policy under the *recognition* and *nonrecognition* provisions. Because of this basic distinction, where realization is concerned, form prevails over substance. Centennial satisfied this historic realization test.[26]

C. The Government's Focus On The Seller's "Economic Position" Would Be Impossible To Administer, Would Allow The Government To Deny Losses Improperly, And Would Boomerang On The IRS When Taxpayers Realize Gains.

The Government proposes to define materiality under Treas. Reg. § 1.1001-1(a) by looking to whether both parties to an exchange "knew" or "cared" about differences between the properties exchanged and to how the marketplace

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[25] Beyond sales or exchanges, realization of income under current law occurs under a watered-down test turning on almost any "definite event." 1 Bittker & Lokken 5-10.

[26] The Government is wrong in saying here that the Sixth Circuit relied on § 1001(c) in holding that there is no "materially different" requirement for realization on an exchange of property. Gov't Brief at 16. The Sixth Circuit held that Cottage Savings realized its loss because the genuine decline in market value of its existing mortgage loans "was fixed by an identifiable event – the 'reciprocal sales' transaction." 890 F.2d at 852. This statement expresses the historically correct common law test of realization of gain or loss from an exchange of property, and is not based on the recognition rule of § 1001(c).

"viewed" any differences that might exist. It is hard, and the lower courts in the related cases found it hard, to distinguish this type of argument from merely comparing objective market values of the mortgages and finding materiality lacking if the fair market values of the old and new obligations are equal. The Government's theories about subjective perceptions of various "interested parties" concerning changes in a seller's economic position, if they have any merit at all, belong in a debate over nonrecognition policy for gain and loss in our tax law.[27]

On its inherent merits, the Government's theory is administratively unsound and would boomerang on the tax collector. We predict that if this Court upholds the Government's "economic" definition of materiality, the IRS will find it necessary to renounce its victory. The Fifth Circuit correctly points out in *San Antonio* that the Government is really arguing for a "universal" like-kind rule of nonrecognition in the guise of realization theory. 887 F.2d at 589. If the Government prevails, there would be little role left for Sections 1031, 1091 and other nonrecognition provisions except where elaborate trials had first demonstrated that exchanged properties differ from each other economically. Administratively, the tax system would approach collapse if we try in every exchange to identify the "economic actors" (Gov't Brief at

[27] The Government supports its "marketplace" perspective on exchanges with several court decisions. Gov't Brief at 22. However, in *Hanlin v. Commissioner*, 108 F.2d 429, 430 (3d Cir. 1939), the Third Circuit's reference to the "habits" of holders of stocks and securities relates to the statutory wash sale rule of § 1091 which is a *nonrecognition* provision. The Second Circuit's reference in *Emery v. Commissioner*, 166 F.2d 27, 29 (2d Cir. 1948), to the "investing public" was followed by this statement: "That the public considered the difference material is shown by the fact that the market value of the new bonds was higher than that of the old bonds which were still outstanding when the exchange was complete." 166 F.2d at 29. This statement indicates that the Government's discussion of marketplace perceptions is equivalent to testing properties for material difference by comparing their market values – a proposition the Government denies it is proposing. *See* Gov't Brief at 23 n.19.

21) such as the taxpayer, his trading partner, the Bank Board and the public marketplace, determine their views, compare them, and then decide what to do if their perceptions differ. Blind men would have an easier job identifying an elephant.[28]

On the other hand, taxpayers, for their part, could seemingly use the Government's own arguments to claim nonrealization of *gains* from exchanges of appreciated assets, since Treas. Reg. § 1.1001-1(a) does not distinguish between income and loss. If taxpayers could successfully exchange appreciated stocks, bonds or other assets which happen to be in the same industry or are otherwise affected by the same "market forces," or could contend that they did not "know" detailed economic facts about the stocks or other assets they own, or that they were so indifferent to their assets that they allowed their broker to decide when to replace them, and that their gains were therefore not realized under the Government's subjective perception theory, the potential revenue loss would be staggering.

If the Government institutes its "perception" test for gain or loss, the potential also exists for a nonstatutory *wash sale* rule that would actually exceed in scope the existing wash sale provision of Section 1091. The courts have long applied a narrow form of nonstatutory wash sale by disallowing losses from sales of stocks or bonds reacquired by the *seller* himself, or by a party *related* to him, beyond the 60-day wash sale period under a prearranged plan.[29] Stocks and bonds of different companies may also be substantially identical where there are predecessor and successor companies in an acquisition or where arbitraging occurs just before a merger. *See* Treas. Reg.

[28] The fact that the Government accuses the Fifth Circuit of "substituting its evaluation" of the significance of different debtors and collateral for that of the parties themselves (Gov't Brief at 28) illustrates the inherent ambiguity and administrative difficulty in relying on material difference as a tax test of realization.

[29] *Shoenberg v. Commissioner*, 77 F.2d 446 (8th Cir.), *cert. denied*, 296 U.S. 586 (1935), illustrates this situation, but in citing this decision the Government fails to mention that an alter ego of the seller reacquired the stock under a prearranged plan.

§ 1.1233-1(d)(1). However, stocks or bonds issued by different corporations are generally considered not substantially identical under the existing wash sale rule even if the two companies conduct the same type of business "and their securities are responsive to the same winds of economic change."[30] This rule "enables astute investors to sell their depreciated securities at a loss without relinquishing a position in a particular industry or business area." A different rule "requiring the future internal policies of the two companies to be compared would invite, if not require, expert testimony between investment counselors that would degenerate into a battle of words about hopelessly imponderable business prospects."[31] Yet that is precisely the scenario which the Government's argument would create if gain or loss is not realized unless properties exchanged are not economically similar to each other. The tax collector would effectively require an owner of property to leave entirely the same business field where the same market forces operate or not to sell for cash and purchase property of the same kind with the proceeds.

Further, if IRS is successful here, it could create a non-statutory wash sale rule for *gains* by attacking year-end sales of appreciated securities (or other assets) where the seller hopes to shelter a realized gain with expiring net operating loss carryovers or previously-realized losses and then acquire the same or similar securities at a stepped-up basis. This result is not forbidden by the current Code.

The Government appears to believe that it has another string to its bow among the "economic" theories it is advancing here. The Government suggests that the mortgages exchanged by Centennial should be governed by the Fifth Circuit's dictum that gain or loss is not realized from exchanges of "fungible" goods. Gov't Brief at 22; *see also San Antonio*, 887 F.2d at 583. This dictum is an error by the Fifth Circuit and should be rejected by this Court. It is basic to the historic realization concept, discussed earlier, that gain or loss is realized from an exchange of two truckloads of nuts

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[30] 2 Bittker & Lokken, 44-105.

[31] *Id.*

and bolts, two gold coins, two bushels of wheat, two tankers of oil, or two adjoining subdivision lots. There is no rule in existing tax law supporting the Fifth Circuit's view regarding exchanges of fungible goods, and consequently no support for the Government's "fungible goods" justification for a "marketplace" perception test of realization.[32]

Finally, the Government is wrong in suggesting that the Court ought to view the thrifts' exchanges as involving "pools" of loans rather than aggregates of individual loans.[33]

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[32] The like-kind nonrecognition rule of § 1031 excepts "stock in trade," which implies that gain or loss is realized from an exchange of fungible items. The IRS is already on record that gain or loss is realized from exchanges of fungible goods. *See* Tech. Advice Memo. 8043017 (July 23, 1980) (exchanges of fungible commodities result in realization and recognition of gain or loss); *see also* Limberg, *Treatment of Oil Exchanges Between Companies: What Basis for Nontaxability?*, 64 J. Tax'n 38 (1986).

[33] See Gov't Brief at 18, 23. The idea may be that the Court should view the exchanges as involving two mass assets which had the same net risks. Gov't Brief at 19. If so intended, these references to pools would revive an IRS argument rejected by the Tax Court in *Cottage* and *FNMA* that the mortgages exchanged were "mass assets" which the courts have held are nondepreciable. The Tax Court rejected this analogy on the ground that the courts have held the mass asset concept inapplicable to obligations to pay money (such as mortgages). *See Cottage Savings*, 90 T.C. at 396-97; *FNMA*, 90 T.C. at 423-24. It is also inaccurate to define the mortgages here as "pools," because pools involve combining cash flows from a group of mortgages and redirecting their income to third persons who buy rights to specified income streams produced by the "pool" as a whole. The "REMIC" provisions of §§ 860A through 860G are an example of true mortgage pools. By contrast, in the instant cases, each homeowner's monthly payments went solely and only to the new owner of that particular mortgage and no one else. There was no pooling of overall cash flows and redirection of the combined income stream to other investors.

D. The Sixth Circuit's Rationale Under Section 165 Would Turn That Section Into A Nonrecognition Rule For Exchanges.

In *Cottage Savings* the Sixth Circuit essentially moved over to Section 165 the Government's argument under the realization category – lack of change in the thrift's economic position – and concluded that the loss could be viewed as not "sustained" under that rationale. The defect in this view is that Section 165 has never before been treated as a "sister" nonrecognition rule for losses from exchanges of substantially identical assets.[34]

In its brief the Government does not advocate the Sixth Circuit's use of Section 165, but suggests that Sections 1001 and 165 both express the same idea of realization and therefore that "substance over form" under Section 165 applies equally under Section 1001. Gov't Brief at 16 n. 11. This assertion attempts to throw sand in the Court's eyes. It is wrong to imply, based on the cases listed in footnote 11 of the Government's brief, that the thrifts' exchanges lacked economic substance. The cases cited by the Sixth Circuit involve situations where a seller prearranged to acquire the identical asset (or the identical property right in the same asset) as the asset he sold rather than acquiring "substantially identical"

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[34] The Sixth Circuit's effort to treat the losses as recognized but not deductible also creates a serious inequity for the taxpayers. If the taxpayer had realized and recognized its loss, each S&L would presumably take a current fair market value basis in its acquired mortgages. Since that value is less than the unpaid principal amount of the acquired mortgages, each party to the exchange would realize income as it makes collections on the acquired mortgages in excess of the new owner's tax basis in the mortgages. Cottage Savings thus permanently loses any deduction for the decline in market value of the mortgages it disposed of, but must still report income on its collections on the acquired mortgages. If the statutory wash sale rule had applied, by contrast, the loss deduction would be denied but Cottage would carry over its (higher) basis in the mortgages sold to the mortgages purchased, thereby eliminating the collection income.

assets.[35] Centennial did not reacquire any of the transferred mortgages from FNMA. Second, it is wrong to claim that a transaction lacking economic substance for Section 165 purposes "can be viewed" as simply another way of saying that no loss is realized within the meaning of Section 1001. Gov't Brief at 16 nn.11 & 12. "Substance over form" is utilized under Section 163 or Section 165 to police a variety of "transactions" in which taxpayers do not part completely with ownership of an asset or enter into "tax shelter" investments with a primary tax motive to *create* tax deductions.[36] But where a taxpayer (such as Centennial) has already suffered a drop in the market value of its portfolio mortgages due to increased interest rates, the owner of the asset is permitted to choose the time when he wants to realize his loss by disposing of the asset.[37] "Substance" does not require that Centennial (or any other thrift) must receive property in an exchange which is not of the same general kind or which is not affected by the same market forces.

In sum, even if this Court might be inclined to agree in the instant case and in *Cottage Savings* that different obligors and collateral make the mortgages materially different in those situations, we submit that the "differing materially" test

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[35] In *Higgins v. Smith*, 308 U.S. 473 (1940), cited by the Government, the Court stated the correct general principle under § 165 that "the loss is sustained when realized by a completed transaction determining its amount." 308 U.S. at 475. The Government has not disputed that there was a completed transaction via a complete termination of Centennial's ownership of the 90 percent interests in mortgages it transferred.

[36] See, e.g., *Freytag v. Commissioner*, 904 F.2d 1011 (5th Cir. 1990); *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988); and *Sheldon v. Commissioner*, 94 T.C. 738 (1990).

[37] In *Yosha*, after discussing substance-over-form criteria applicable to tax shelters, Judge Posner added this caveat: "*Gregory v. Helvering* is different from the myriad instances where the taxpayer times the sale of an asset to offset a capital gain or to take advantage of a capital loss." 861 F.2d at 497.

itself has outlived its usefulness. This Court should reject not only the Government's proposed theory of "differing materially" but also that criterion itself as a rationale for upholding the claimed deductions.

Unless and until our tax law shifts completely to taxing unrealized appreciation and allowing unrealized losses, the realization thread from the old Supreme Court cases should be preserved under easily-administered bright lines. This means that gain or loss should be considered realized from every exchange of property so long as the taxpayer/seller terminates his beneficial ownership of the property transferred, regardless of the economic nature of the property received. If the transaction involves a change in terms of a contract right or debt obligation, gain or loss should be considered realized if the taxpayer's property rights are changed in any way, regardless of the degree of change. (Any prearrangement to reacquire the same property, or an acquisition by a person related to the taxpayer, should be treated as not a true disposition in the first instance).

Whether the parties to a sale, exchange or change in terms of an obligation or contract should incur current tax consequences is a question of *recognition* or *nonrecognition* of gain or loss or, if Congress desires, of specific exceptions to general statutory rules. On that playing field, the "economic" similarities or differences between properties should be reflected, as they now are, in recognition or nonrecognition provisions of the Code. Exchanges of mortgage portfolios are no different from taxable exchanges of any other kinds of similar assets. That fact is not altered merely because (as in Centennial's case) the Code contains no nonrecognition provision to help the Government deny the loss deductions.

II. CENTENNIAL CORRECTLY TREATED ITS INCOME FROM PREMATURE TERMINATION OF TIME DEPOSIT ACCOUNTS AS INCOME FROM DISCHARGE OF INDEBTEDNESS BECAUSE THERE WAS ONLY A SINGLE RELATIONSHIP OF DEBTOR AND CREDITOR BETWEEN CENTENNIAL AND ITS DEPOSITORS.

The U.S. League strongly supports the Fifth Circuit's classification of Centennial's income from premature termination of its certificate of deposit accounts ("CDs") as arising from discharge of indebtedness for purposes of Section 108.

There are only two determinations that need be made in order to determine the correct tax character of Centennial's income. The first is whether the banking terminology referring to a "penalty" on the customer prevents the existence of only a single relationship between the parties in which Centennial was the debtor and the account holders were creditors. The second is whether, even if there was at all times only a relationship of debtor and creditor between Centennial and its depositors, the deferral election under Section 108 was intended by Congress to be confined to financially-troubled debtors.

We believe that (1) the "penalty" terminology in the banking regulations should not be given significance for tax purposes, and that (2) Section 108 is not limited in its scope as contended by the Government.

1. Massive question-begging runs throughout the Tax Court's analysis, the Seventh Circuit's opinion in *Colonial Savings Association v. Commissioner*, 854 F.2d 1001 (7th Cir. 1988), *aff'g* 85 T.C. 855 (1985), *cert. denied*, 109 S. Ct. 1556 (1989), and the Government's brief herein. The bank regulations providing for a "penalty" on the depositor, and the banking purposes for "penalizing" the depositor, create only neutral facts. It does not automatically follow, and the Government never establishes, that *for tax purposes* there existed a separate and distinct "obligation" on the customer to "pay" something to the bank. The "penalty" concept served a nontax function in banking rules by rationalizing *for the customer* his receipt of less than the full amount otherwise due him. That

function is not relevant to the special concepts of income tax law characterizing the *debtor's* income. The Tax Court judges who decided the mortgage exchange issue currently before this Court (see Issue I, *supra*) emphasized that benefits and burdens imposed by regulatory agencies for nontax purposes do not control the meaning or application of tax rules which have their own policy purposes. *See Cottage Savings*, 90 T.C. at 402.

The Government's contention that the banking regulations created a separate relationship between the parties might have some validity if the "penalty" or "forfeiture" grew out of a relationship between Centennial and its depositors other than the original CD account. But it does not. By reciting the regulatory purposes for imposing a "penalty" or "forfeiture" on the depositor – i.e., deterring early withdrawal, minimizing the bank's costs, facilitating long-term investments, etc. (Gov't Brief at 34) – the Government does not *ipso facto* establish that the "penalty" was "imposed from outside the debtor/creditor relationship." *See id.* The banking rules give various reasons why the bank or thrift does not have to repay the depositor in full. But those reasons still relate to the original CD account and do not create a separate obligation between the bank and the depositor, unless the Government first establishes that the tax concept of discharge of indebtedness is inapplicable in light of these *nontax* policies. However, the Government never establishes that the debtor cannot suffer discharge of indebtedness for tax purposes because of the banking policies rationalizing less-than-full repayment to the depositor.[38]

2. The Government engages in classic question-begging when it asks this Court to view the early withdrawal transaction as though Centennial had repaid the depositor in full after which the depositor turned around and paid his penalty to

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[38] The Seventh Circuit in *Colonial Savings* also recites various banking purposes for the "penalty" on the depositor, but never justifies *ab initio* using those purposes to control federal income tax results and applying them to determine tax effects to the debtor.

Centennial. Gov't Brief at 33. This argument assumes (again, without supporting authority in the tax law) that a separate obligation was created by the banking term "penalty." The more correct way to consider alternatives is that if a depositor had purchased a CD which prohibited withdrawal before maturity, but later offered to accept less than the full principal and accrued interest because interest rates had risen and the depositor wanted to earn a higher return elsewhere, pure cancellation of debt would clearly occur and a Section 108 election could be made. *See* Rev. Rul. 82-202, 1982-2 C.B. 36. If the parties had agreed in advance on the cost to the depositor for obtaining his funds before maturity, the substance of the arrangement would be exactly the same as if the terms had not been negotiated in advance. It is hard to see why agreeing in advance on the reduced amount which the thrift will repay *ipso facto* creates an "obligation" separate from the underlying CD account, or justifies treating the agreed (or prescribed) reduction in repayment as anything but an indivisible part of a single debtor-creditor relationship.

3. The Government argues that even if viewed as part of the original debtor-creditor relationship, the penalty is not intended to resolve the debt but rather to "compensate" the bank for its expense caused by the early termination. Gov't Brief at 34-35. This argument, if accepted, will eliminate many true discharge of debt situations because every situation where a creditor initiates the settlement can be verbally described as "compensating" the debtor for his loss of use of the borrowed funds. The tax category of discharge of indebtedness should not be interpreted away by such verbalisms.

4. The premature withdrawal transaction satisfied one of the main criteria for "true" versus "spurious" debt discharges: the creditor is entitled to a loss deduction. In a genuine debt discharge, the creditor is ordinarily entitled to deduct a loss or worthless debt, whereas in a so-called "spurious" situation, the creditor is not entitled to a loss deduction "because no loss has been suffered." 1 Bittker & Lokken, 6-50. As applied here, the creditor (depositor) could deduct his loss on the discount under Section 62(a)(9) of the Code. This loss deduction by the creditor supports Centennial's

contention that the premature withdrawal of the CD account produced true cancellation of indebtedness income.

5. The Government's strained effort to suggest that Congress intended to limit the deferral election permitted by Section 108 to insolvent or financially needy debtors is unsupported and unjustified. Gov't Brief at 38 & n.36. The statutory language of Section 108 is not limited to circumstances where debtors need an incentive to liquidate their debts. Gov't Brief at 38. The legislative history cited by the Government merely lists some circumstances in which income deferral can be elected, but these transactions in no way exhaust the scope of Section 108. Gov't Brief at 30 n.25.[39] Significantly, leading commentators have rationalized discharge of indebtedness income under Section 61(a)(12) and the deferral allowed by Section 108 on the ground that income arises, not by reference to the debtor's financial condition, but as a way of offsetting the initial benefit which a borrower receives when he obtains untaxed borrowed funds but then incurs deductible expenses with those funds.[40] A "bunching" problem arises, however, from telescoping the income into a single year, since the income represents a recapture of expenses incurred over many years with the original borrowed funds. The basis reduction provisions of Sections 108 (and 1017) provide relief from the bunching problem (via deferral), while still preventing the debtor from using untaxed loan proceeds to depreciate assets purchased with those funds.[41]

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[39] The Government agrees that § 108 can apply to creditor-initiated transactions (Gov't Brief at 38) but tries to narrow those transactions to on-the-spot bargaining between the parties and to cases where the debtor has some control over the outcome. Gov't Brief at 38 and 39 n.37. The Government cites no authority for any such limitations.

[40] 1 Bittker & Lokken, 6-32; M. Chirelstein, *Federal Income Taxation* 53-54 (Foundation Press 4th ed. 1985); Eustice, *Cancellation of Indebtedness in the Federal Income Tax: A Problem of Creeping Confusion*, 14 Tax L. Rev. 225, 229-30 (1959) [hereafter "Eustice"].

[41] Eustice, *supra* note 40, at 258-59.

6. Overall, the Government attempts to "color" the general tax definition of a discharge of debt by giving it a flavor of "mercy," that is, discharge of indebtedness arises for tax purposes where all or a portion of the debt is "forgiven." Gov't Brief at 34. The implication is that Centennial's depositors intended no such forgiveness here. However, Section 108 does not use the term "forgiveness" or "cancellation." Both Sections 108 and 61(a)(12) use the neutral, all-inclusive term "discharge." This neutral terminology does not require that the transaction be initiated by the debtor (to reduce his debt burden) rather than by the creditor, or negotiated at the time of the discharge. Nor does the Code require that the creditor possess a spirit of forgiveness. Professor Bittker has emphasized that the taxability of gain from discharge of indebtedness should not depend on the specific type of debt incurred, but merely on the objective spread between the amount received by the debtor originally and the amount he repays to satisfy his obligation. 1 Bittker & Lokken, 6-34. If the original debt is repaid for less than its face amount and there is no separate relationship other than as debtor and creditor, there is a discharge of indebtedness. That is what happened here.

CONCLUSION

For the foregoing reasons this Court should affirm the decisions of the Fifth Circuit on both the loss deduction and discharge of indebtedness income issues.

Respectfully submitted,

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